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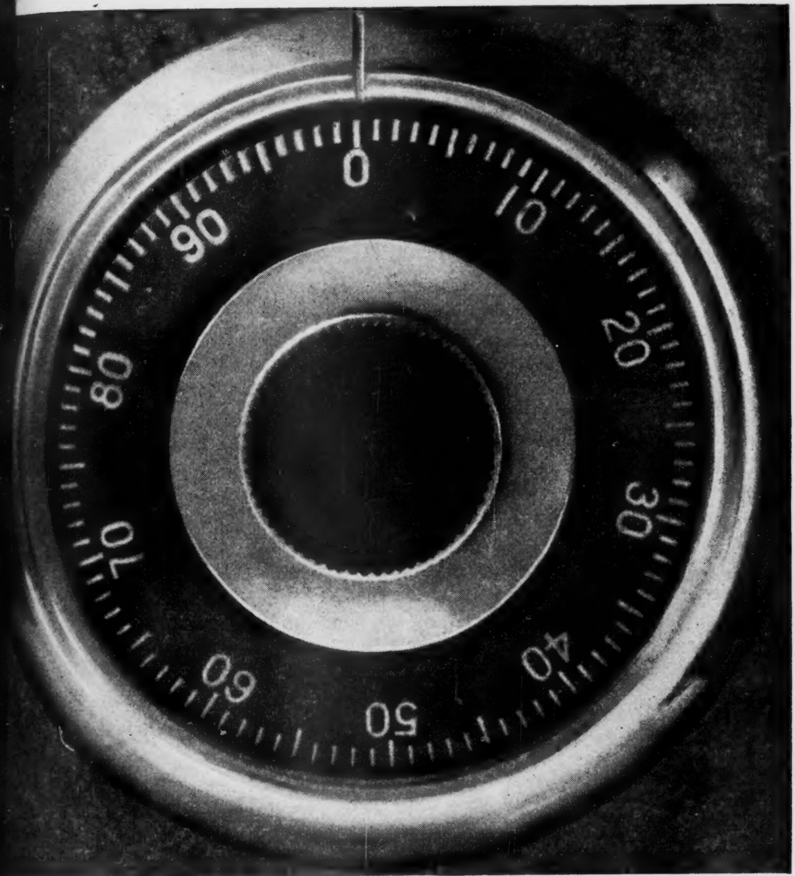

THE NEW YORK

CPA

OCTOBER 1959

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CONTENTS

DEPARTMENTS

Accounting News And Trends

ADVICE TO BANKERS AND CPAS

Advice to both sides is offered by Mr. William R. Chapman in his article "The Accountant and the Banker Walk the Tightrope Together" (ROBERT MORRIS ASSOCIATES BULLETIN, April 1959). Three suggestions to the accountants are:

1. Don't underestimate the value of a "certified" report. Bankers find it discouraging that some CPAs only certify a report when it is insisted upon and, when presenting it, have been heard to remark "We really don't need all of this." The author cites an instance in which the bank had requested a certified report and a CPA friend of the accountant who had been doing the audit visited him to point out that such a report was not truly necessary. Mr. Chapman's years of experience, however, have convinced him that the interests of the businessman, the banker, and the accountant are all best served by a certified report.

2. Don't feel constrained to advise your client that the bank is charging too high an interest rate unless you have clear and complete evidence that this is the fact. When a businessman complains to the bank about the fee charged by the accountant, the response is that ignorance of the time required and the factors involved makes it impossible to judge the fee. A similar attitude towards the bank's interest charges would seem appropriate.

3. Don't hesitate to reveal to the banker when you are having problems with the client as to the restriction of the engagement. Since both the banker and the accountant have the same interest, they should be able to work together on this problem.

In his advice to bankers the author points out that one of the most valuable tools is accurate and complete financial information. All bankers should urge their borrowers to arrange for adequate audits consistent with their needs, and the bank's needs. Bankers themselves need to improve their own understanding of audit standards and procedures if they are to do their part in seeing to it that reporting by the auditing profession gives the proper information. Bankers should make it clear to the accountant and to the client just what is required in the way of financial data. Finally, bankers should refuse to accept unsatisfactory audits and should endeavor to persuade borrowers to permit unrestricted audit engagements.

As an example of incomplete auditing, the audit of a local wholesale concern in which the CPA gave an opinion "subject to the above comments" was cited. The comments included: "The accounts receivable were verified by test check to the subsidiary ledger and were found to be in agreement with the control account. We did not confirm the balances with the debtors . . . we were informed that the merchandise inventory was taken, priced at lower of cost or market and extended by the management. No verification of this inventory was made." Since the receivables and inventory represented 93 percent of the total assets, the

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ACCOUNTING NEWS AND TRENDS is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Legislation. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.

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value of the CPA's opinion was highly questionable.

Suggested areas in which bankers and accountants can cooperate to their mutual benefit include:

1. The development of a standard form for contractors' statements.

2. Since much property is leased and borrowers are often obligated to pay substantial future rentals, the inclusion of a list of all leases outstanding with a resume of their terms is often desirable.

3. Where borrowers operate under a loan indenture, it is important that bankers be informed whether the agreement is being observed and accountants should include this investigation in their engagement.

STOCK TRANSFER AND DIVIDEND-PAYING AGENTS

A summary of the replies of eight companies regarding the pros and cons

of companies acting as their own stock-transfer and dividend-paying agents (THE CONTROLLER, April 1959) suggests that there are many aspects to this problem.

Of the eight respondents, two employ outside transfer agents; two perform these operations in their own departments; and four utilize outside services for the stock-transfer operations but perform either all or part of the stock recordkeeping and dividend-paying operations in their own organizations. Cost alone is not the determining factor. Indeed the estimates of the number of stockholders required for a company to save money by performing the operations itself varied from under 1,000 stockholders to over 100,000 stockholders and suggest there is little accurate cost information on this point.

Reports indicate that companies prefer to perform these operations because they feel that they can maintain a closer control of records and give stockholders better and more personal service. Other companies continue to have banks perform these services either to maintain a happy banking relationship or to avoid responsibility for the various legal considerations involved in the validity of endorsements and transfers.

On the basis of this small survey it is apparent that no hard and fast rule can be stated regarding a "best" way of handling these operations. The replies do indicate, however, that companies undertaking surveys on this matter should consider (1) possible economies, (2) stockholder relations, (3) banking relationships, and (4) the legal aspects involved, before making decisions to change their present procedures.

SOLICITATION AND PURCHASE
AND SALE OF ACCOUNTS

An opinion on "selling" accounts published by the Illinois Society of

CPAs' Committee on Professional Conduct (NEWSLETTER, March, 1959) is well worth examining. The committee first points out that when a sole practitioner dies or retires, it is not unusual for an established practitioner to acquire the practice of such individual and to compensate the estate of the decedent or the retired individual in some manner. This should be helpful not only to the estate or the individual but also to his clients who may thereby be assured as to continuity of attention to their accounting problems.

Where, however, persons or firms who are not CPAs or registered Public Accountants, either solicit accounts which they then "sell" to public accountants, or themselves service such accounts for some period and thereafter "sell" such accounts, the CPAs or registered PAs who "buy" such accounts are, in the opinion of the committee, in violation of Rule 7 (prohibiting solicitation) of the Rules of Professional Conduct of the Illinois Society. If the persons or firms who "sell" accounts to practitioners merely solicit such accounts with a view to their immediate, or almost immediate, "sale" (i.e., serving them only so long as they have not been sold, while making continuous efforts to sell them), it may well be asked: "For whom did the seller solicit the accounts in the first instance, if not for the prospective purchaser? And accordingly, may not the solicitation be imputed to the purchaser?"

It was the opinion of the committee that such solicitation is in fact imputable to the purchaser. Furthermore, where the consideration paid for accounts thus acquired is measured in a stated number of months' billings to the clients thus acquired, i.e., the source of the payments is the fees collected from the clients, the

Committee further held that such fees are thereby shared with the laity in violation of Rule 3.

TAX ALLOCATION AND PURCHASE OF ASSETS

An interesting problem of income tax allocation is presented in THE ARTHUR YOUNG JOURNAL (April 1959). It involved the determination of the preferable method of allocating the excess of purchase cost over the net book value of assets acquired in a business combination which was a purchase for accounting purposes but a tax-free merger for income tax purposes.

Net assets had been purchased by the issuance of stock which had a fair market value considerably in excess of the net book value of the assets acquired. It was proposed that a substantial portion ($1,000,000) of this excess be allocated to depreciable fixed assets, based on a recent appraisal, and that the remaining excess be considered an intangible asset. The question was raised as to whether the $1,000,000 to be allocated to fixed assets should be reduced by 52 percent in recognition of the fact that the gross amount would not be deductible from taxable income for tax purposes in future periods and thus would have a reduced economic value, a factor which was not taken into consideration in the independent appraisal. It was concluded that the reduction should be recognized and that only $480,000 should be allocated to depreciable property. As a result, the amount allocated to intangible assets was increased by $520,000.

An alternative method of accounting would be to add the gross amount ($1,000,000) to depreciable property and to credit the corresponding loss of tax benefit to a deferred income tax account, to be drawn down as the gross amount is depreciated.

Letters to the Editor

DEVELOPING AN ACCOUNTING PRACTICE

Certified public accountants can develop their practices by improved services to clients. In the automobile business, as an example, the dealer, if at all successful will tell you that "Service Sells Cars." This business thinking applied by us can bring about better relations with our clients which would ultimately lead to better fees and to recommendations. May I present several case studies highlighting certain services.

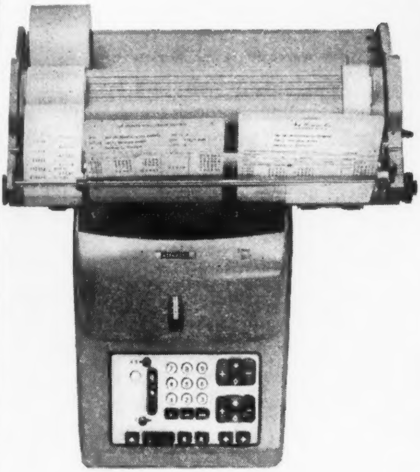
In the following case, the accountant's specialized knowledge of budgeting was applied very productively and helped to save a business headed for failure. The client, a distributor for a national manufacturer, was not making any progress and in fact was growing progressively worse. His accountant, after some research, was able to obtain some comparative operating statistics of other distributors. Applying these findings to his client's operations, it became apparent that operating expenses were too high. With this knowledge, the accountant reviewed in detail every item of expense and indicated to his client the unfavorable variations as compared with other distributors. To bring the expenses in line was no easy task, but it had to be done to remain in business. The accountant's findings revealed also that the client's gross profit on sales in the various departments was out of line compared with other distributors. A study revealed that trade discounts were given too liberally. As a result of this disclosure, a firmer discount policy was set up without any appreciable drop in sales volume.

To effectuate these changes and establish controls, a monthly budget was set up enabling the client to compare actual results with estimated budget figures. Unfavorable variations from the budget were examined immediately for corrective purposes. In this particular case, the accountant recognized the problem and worked closely with the client for a satisfactory solution resulting in a satisfied client who was willing to pay a higher fee for services rendered.

Let us examine the following case wherein the accountant helped both in speeding up of collections and in effecting greater office efficiency. In the audit of accounts receivable, he noted an increasing trend in past-due accounts. After bringing this fact to the attention of the client, it was discovered that monthly statements were being mailed too late. Many customers, upon receiving such statements after the 10th of the following month, did not pay their bills for another 30 days. The bookkeeper explained that she was not able to start preparing the statements for over 250 customers until after the 5th of the next month and even later. The accountant observed that the solution to this problem was machine bookkeeping wherein the statements are prepared simultaneously with the ledger posting. However, the financial condition of this client did not permit any expensive setup. Recalling the various bookkeeping machines from a recent visit to the business show, the accountant recommended one that was within the price range of the client.

We should recognize our clients' problems. This is a positive approach toward maintaining and developing your accounting practice. The accountant not only has to be a good auditor, but a good observer as well, keeping in close contact with the client's business.

After reading this, I trust it will



evoke an interest in our members to submit some of their experiences to the editor for publication in the "letters to the editor" department.

RALPH BOROD, CPA
(Borod & Kraus)
New York, N. Y.

SPECIAL INSURANCE REQUIREMENTS OF AN ACCOUNTING FIRM

As accountants, we are very much aware of the need of our clients to carry special insurance to protect them against their risks, but only too often we neglect our own need for special insurance as accountants. It is the purpose of this "letter to the editor" to point up some of these features.

A relatively new and very valuable supplement to the basic fire insurance policy for accountants is the Office Contents Special Form. This supplement covers "all risks" of direct physical loss to the contents of an accountant's office except those risks that are specifically excluded from the policy. In order to avoid the analysis involved and the danger in omitting coverage of a risk when insuring, insurance companies will issue an "all risk" policy which covers the various risks for which an insured desires coverage. Accordingly, the Office Contents Special Form protects the contents of an accountant's office from all physical loss or damage except for listed exclusions while they are within his office and to a limited extent (i.e. 10 percent) contents which are outside his office. The contents of the office are considered to include furniture, fixtures, equipment and supplies. Some of the risks covered are:

1. Water damage and sprinkler leakage.

2. Burglary, theft and robbery. However, the loss of money and stamps is limited to $250 and to loss on the premises.

3. Personal effects of the insured or others on the premises up to 5 percent of the amount insured for fire or extended-coverage perils.

The Office Contents Special Form has a $50 deductible clause which applies against all losses except those caused by fire, extended coverage perils, burglary or robbery.

Among the risks not covered by the Office Contents Special Form are the cost of replacing destroyed records and losses due to dishonesty of employees.

An accounting firm has many records which are most valuable to the firm in the conduct of its business, but which are worth no more than the paper on which they are written. If such records were destroyed, the loss would amount to far more than the cost of material for reproduction of the records. Valuable papers insurance would reimburse the accounting firm for the actual cost of reproducing or replacing the lost, destroyed or damaged property.

Valuable papers insurance is another type of "all risk" insurance. Accordingly, valuable papers insurance protects the accounting firm from all loss or damage to valuable papers while within the firm's premises. There is an extension of the coverage not exceeding 10 percent of the combined limits of insurance, but in no case in excess of $5,000, while the papers are being conveyed outside the premises or temporarily within other premises for any purpose other than storage.

The term "valuable papers" does not include currency, postage stamps, coupons, securities, checks, any written evidence of debt and similar papers.

PHILIP ZIMMERMAN, CPA
(Robert Simons & Co.)
New York, N. Y.

THE PRESIDENT'S PAGE

Independence

It's a strange thing that, while practicing accountants across the country talk frequently about independence being the foundation of the public accounting profession, practically none of the rules of professional conduct makes any reference to the word. In our own State Society the word is not mentioned in the rules. It is true, of course, that many of the codes have references to certain matters relating to independence—contingent fees, sharing fees with the laity, the ownership of clients' securities, etc.—but most of them have nothing that is at all specific. One might indeed wonder why, if independence is as important as we all say it is, it is not given a prominent place in all our codes.

The reason for this omission seems to be that historically the profession has tended to look upon independence as a mental attitude not possible of definition, and has reasoned that if the accountant was not impartial and objective this fact would soon become evident in his work. In recent years there has been a decided change in this philosophy and there is a growing feeling that the codes should place more emphasis on the matter.

In 1954 the Illinois Society pointed the way by adopting a rule to the effect that an auditor should not express an opinion on financial statements unless he was in fact independent and that, for example, he would not be considered independent if he had any financial interest in his client or if during the period of the report he was connected with the concern as a director, officer, promoter, etc. The ethics committee of the American Institute also has moved in this direction and at its

Spring meeting it approved unanimously a somewhat similar rule which is now out for exposure with State Societies, State Boards of Accountancy and other interested parties. The independence rule of the Illinois Society and the proposed rule of the Institute parallel the SEC's rule on independence.

While the various reactions to the proposed Institute rule have not yet been tabulated, it is reasonable to assume there will be controversy among the members just as there was in the case of the Illinois rule. The difficulty is that when we get into specifics we concern ourselves with the appearance of wrongdoing rather than with wrongdoing itself. Many accountants are strongly of the opinion that they can own securities in a client or be a member of the client's board and still have a completely independent state of mind. They say it is casting a doubt on the integrity of a member to suggest that his objectivity can be so easily influenced. They also point out that any undue emphasis on independence might very well raise questions about whether an accountant can be independent when he cooperates with management in other areas such as tax work and management services.

Admitting that there is merit to some of the arguments against a specific rule on independence, there does seem need for guidance as to those situations where an accountant's independence may be open to question. We have to realize that in expressing opinions on financial statements the accountant adds credibility to them and if readers have doubts of a CPA's independence because of his having a financial interest in a concern or being on its board, they are not receiving the maximum benefit from the accountant's opinion.

It is too early to predict what kind of a rule on independence will be approved by the Institute but it seems fairly evident that we will hear much more about independence in the coming years and that a number of the codes will eventually incorporate a rule which will be in the direction of the viewpoint of the SEC and the Illinois Society.

THOMAS G. HIGGINS,
President

Accountants' Legal Liability

By THOMAS W. HILL, JR., CPA

The first part of this article, which was published in the March 1959 issue, analyzed the broad basic principles of accountants' legal liability. This concluding installment makes detailed reference to decided cases in clarifying the applicable legal doctrines. Some of the major topics which are afforded extended treatment are: liability for failure to discover defalcations; the extent to which professional literature has clarified the CPA's responsibility for detection of defalcations; required auditing procedures referred to in court cases; and measure of recoverable damages. Appropriate distinction is drawn between liability to clients and to third parties.

LIABILITY TO CLIENTS

IT has been pointed out that the public accountant's liability to his client may rest either on the failure to perform his professional engagement in accordance with generally recognized professional standards, i.e., negligence, or on his failure to comply with the express terms of a written contract.[45]

In the ordinary case where the public accountant has been sued by his client, the audit engagement has been one which called for a simple expression of opinion on the client's statements. The damage alleged by the client has generally resulted from an undiscovered defalcation.

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There have been, in addition, a few cases sounding in negligence resulting from reliance by clients on statements prepared for use in connection with a prospective sale or purchase by the client of corporate stock or assets. The client generally complains that, relying on statements prepared by the public accountant, he paid too much for stock he bought or got too little for stock he sold. Cases of this latter type have also been brought on a breach of contract theory as, of course, have cases resting on the alleged failure to perform a specific task such as filing income tax returns promptly, and the like.

There have also been actions, although they are somewhat older cases, based on the theory that the contract by which the public accountant was engaged was one which required the discovery and disclosure of defalcations.

[45] The first half of this article appeared in the March 1959, Vol. XXIX, No. 3 issue of THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT. The footnotes in this concluding article are numbered in accordance with the prior sequence.

LIABILITY FOR THE FAILURE TO DISCOVER AND DISCLOSE DEFALCATIONS

The cases against public accountants involving the failure to discover and disclose defalcations have rested in almost all instances on allegations that the public accountant was guilty of negligence or, expressed another way, failed to exercise reasonable care in the performance of the audit engagement.

At the outset it must be recognized that the courts have had no hesitancy in holding a public accountant liable for damages resulting from the failure to discover and disclose defalcations. They have expressed little, if any, sympathy for public accountants who take the position that an ordinary audit examination is not designed, at least in part, to detect defalcations.[46] This attitude is not likely to change. The courts will probably, if the recent cases are any indication, impose even stricter standards of performance on the profession.

The profession has had, moreover, great difficulty in defining its own position with respect to its responsibility in connection with defalcations. To date the approach has been a negative one. The professional literature abounds with generalized statements to the effect that the ordinary audit engagement, and the report on financial statements issued as a result of such an engagement, cannot be relied upon as protection against defalcations and should not permit the inference to be drawn by the client that defalcations have not, in fact, occurred.[47] These statements go further to state that a client's best protection comes from an adequate system of internal control and from fidelity insurance.[48]

These statements represent an expression of the only position possible where services of the kind rendered by the public accountant are involved. Unfortunately, however, they do not represent a statement of the position of the profession with sufficient specificity to be of much assistance in particular fact situations. Both the trial and appellate courts have recited these general statements as to the responsibility assumed by the public accountants and have then proceeded to conclude that the public accountant in the particular case before them was liable on the facts involved.[49]

Since it is a fact that the courts have permitted jury verdicts against public accountants to stand and have on a number of occasions concluded that public accountants have been guilty of negligence as a matter of law, an effort must be made to look beyond these generalized statements for a statement or expression which defines the area of responsibility with respect to the detection of defalcations.

PROFESSIONAL LITERATURE

The professional literature dealing directly with the question of the public accountant's legal responsibility does not set forth in what circumstances, if any, a client may rely on the ordinary audit report for protection against defalcations. The most

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[46] See, e.g., *Cereal Byproducts Company* v. *Hall, et al.,* 132 N.E. 2d 27 (App. Ct. Ill. 1956), aff'd 155 N.E. 2d 14 (Sup. Ct. Ill. 1959); 147 N.E. 2d 383 (App. Ct. Ill. 1958), aff'd 155 N.E. 2d 14 (Sup. Ct. Ill. 1959); *Social Security Administration, Baltimore Federal Court Union* v. *United States,* 138 F. Supp. 639 (D. Md. 1956).

[47] Codification of Statements on Auditing Procedure, p. 15 (AICPA 1951).

[48] Carey, Defalcations in Relation to Audit, Internal Control and Fidelity Bonds, 83 Journal of Accountancy 353 (1947).

[49] See note 46, *supra.*

cursory examination of the basic and technical literature of the profession, however, reveals that, at least implicitly, particular areas within the accounts as well as circumstances are established in which a client may rely to some undefined extent on the professional accountant for the discovery of defalcations. The extent to which the client may properly rely will depend upon the accounts involved. The American Institute of Certified Public Accountants has recognized that while the purpose of the ordinary audit contemplating the issuance of a short-form report is directed toward the over-all conclusion that the client's financial statements fairly present the information contained in them, it is also true that the report means with respect to the individual accounts that " . . . they are fairly stated in all material respects in relation to the basic financial statements, taken as a whole." [50]

The distinction between major and minor defalcations is drawn in the professional literature in terms of the liability or obligation for its discovery. This distinction, while a valid one, does not go to the heart of the problem. Whether a defalcation was a major or minor one may have some bearing on an evaluation of the scope of the particular audit program and/or the care exercised in the performance of the examination, but that is all. If a minor defalcation was negligently overlooked it is no answer to argue that the client was only hurt a little bit.

The best source from which to determine how the profession deals with the examination of these various accounts, as well as the public accountant's own recognition of his responsibility for the detection and disclosure of defalcations, is probably the auditing texts presently recognized as authoritative.[51] Examination of any one of these volumes will demonstrate that a large percentage of the procedures recommended as necessary and appropriate in ordinary audit engagements (particularly the procedures relating to accounts such as cash, accounts receivable, inventories and their related liability and income accounts, which constitute the danger areas as far as defalcations are concerned) are procedures which, although designed to permit an expression of opinion that the particular accounts are fairly stated in relation to the statements as a whole, have as a subsidiary purpose a determination as to whether or not there have, in fact, been defalcations or misappropriations. This proposition would seem to be confirmed by recent writings on the question of how the public accountant reaches conclusions relating to the validity of the various accounts examined. [52]

STATEMENT ON AUDITING PROCEDURE NO. 29

Statement on Auditing Procedure No. 29 (October 1958), in Paragraph 7, may permit the inference that a significant purpose of any ordinary examination is to determine whether or not defalcations have occurred. The thrust of the Committee's conclusion is that to the extent that the client's system of internal control, designed for the protection of assets among other things, is inadequate, the audit procedures followed must be expanded or the timing of the application of cer-

[50] Statement on Auditing Procedure No. 27 (July 1957).

[51] See, e.g., Lenhart and DeFliese, Montgomery's Auditing (8th ed. 1957); Bell and Johns, Auditing (rev. ed. 1952).

[52] Mautz, Evidence, Judgment, and the Auditor's Opinion, 107 Journal of Accountancy 40 (April 1959).

tain procedures must be changed to permit an expression of opinion on the statements. This expression of opinion has implicit in it a statement that the audit procedures employed in such examination if performed with due care would have resulted in the discovery of a defalcation, other than one resulting from collusive fraud, having a material effect on the fairness of the statements examined. This would appear to be a recognition by the Committee that, to some undefined extent, the profession has an obligation to protect its clients, perhaps in spite of themselves, against defalcations. It is helpful to bear in mind at this point that there is no standard examination nor any standard client. Each must be dealt with as a separate problem and although the expression of an unqualified opinion is the ultimate aim of the ordinary examination, the routes to such an opinion, the subsidiary purposes of the engagement, if any are contracted for, and the results may often differ. [53]

RELIANCE UPON CPA FOR DETECTION OF DEFALCATIONS

Continual reiteration by the accountants that they cannot and do not state the financial facts in the statements to be literally true begs the question. To say that the ordinary examination incident to the issuance of an opinion respecting financial statements is not designed and cannot be relied on to disclose defalcations and other similar irregularities is to avoid coming to grips with the problem. Admittedly, the courts and the general public continue to rely far too much on the public accountant's ability to detect and disclose defalcations. It is a fact, however, that they do so rely and that they will, in all probability, continue so to rely. Negative protestations on the part of the profession will probably not change to any significant degree the reliance of the lay public in this regard. One need only look as far as the recent cases involving accounting questions but not public accountants as parties, where the word "audit" is equated with the word "verification"[54] and "value".[55] With this view of the work of the public accountant being taken by the highest court of the State of New York it is hard to envision a different view being taken by the lay client or jury. Indeed, the leading writer on this subject recognizes the right of the client to rely on the ordinary examination to a limited but unspecified extent for protection against defalcations.[56]

By the same token, an affirmative statement of general application on the part of the profession does not seem feasible at this time. The ideal solution, of course, is a complete and thorough understanding between the public accountant and his client with respect to how far the client may, or indeed should, rely upon the public accountant's report for protection against defalcations.[57] This solution is subject to obvious practical limitations. A general statement in the letter confirming the engagement or the audit contract, if one exists, may be helpful but is not a complete answer since an area of possible and permissible re-

[53] A Case Study on the Extent of Audit Samples, (AICPA 1954).

[54] *Albert A. Volk Co.* v. *Cauldwell-Wingate Co.,* 272 App. Div. 290, 70 N.Y.S. 2d 662 (1st Dept. 1947).

[55] *Aron* v. *Gillman,* 309 N.Y. 157 (1955); *Pailthorpe* v. *Tallman,* 72 N.Y.S. 2d 784 (Sup. Ct. Monroe Co. 1947).

[56] Levy, Accountants' Legal Responsibility, p. 13 (AICPA 1954). See also, In the Matter of McKesson & Robbins, Inc., S.E.C. Accounting Series Release No. 19 (1940).

[57] But see, Smith, Written Contract with Client Should Not Be Necessary to Define Audit Engagement, 93 Journal of Accountancy 213 (1952).

liance exists in virtually every ordinary audit engagement. Perhaps the only solution, until the professional literature provides a more coherent statement on the subject, is for the profession to look to the decided cases in an effort to spell out the general scope of their responsibility.

SOME BASIC COURT-ESTABLISHED PRINCIPLES

At the outset it can be categorically stated that the courts have uniformly rejected the proposition that, in the ordinary examination leading to the rendition of a short-form report, the public accountant warrants or represents as fact the information either in his report or in the accompanying financial statements.[58] In has also long been recognized that the financial statements are the representations of the client and not the public accountant.[59]

The courts in the very first of the cases brought to recover on account of undiscovered defalcations rejected the argument that the public accountant in the ordinary examination was supposed to act in the capacity of a very special detective charged with the responsibility of detecting each and every peculation and misappropriation of funds.[60]

The decided cases have also affirmatively rejected the proposition that the the audit engagement represents an agreement by the public accountant to protect the client from his own failure to find errors in the books of account or the existence of defalcations.[61]

The courts also recognized that in judging the adequacy of any professional performance, hindsight was invariably better than foresight, stating, in substance, that the exercise of a professional judgment must necessarily be limited by available knowledge and the absence of circumstances giving rise to suspicion.[62]

The recent *Cereal Byproducts* case [63] discussed the liability of the defendant public accountant for negligence where an ordinary short-form opinion was rendered and, in concluding that the public accountants were negligent, stated:

> . . . it is necessary that certain examinations or checks be made which would show defalcations before the auditor could render an opinion on the balance sheets and financial statements as showing the worth of the firm whose books were examined.

With this general proposition the expert accounting witnesses called by the defendants as well as the plaintiff agreed.[64] In the context of the facts involved in the case the statement is somewhat ambiguous since the appel-

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[58] Charge of the Court, *First National Bank of South Bend, South Bend, Indiana* v. *Small, Greenburg, J.*, p. 1648 (April 24, 1956), aff'd without opinion, 6 App. Div. 2d 679 (1st Dept. 1958).

[59] *Social Security Administration, Baltimore Federal Credit Union* v. *United States,* 138 F. Supp. 639, 657-8 (D. Md. 1956); *In re Interstate Hosiery,* 4 S.E.C. 706, 721 (1939). This, of course, coincides with the position of the profession. See, e.g., Statement on Auditing Procedure No. 25, paras. 13, 14, 29-35 (AICPA 1954); Codification of Statements on Auditing Procedure, pp. 14, 15, 49 (AICPA 1951).

[60] *In re Kingston Cotton Mill Co.* (1896) 2 Ch. 279 (C.A.); *The Irish Woollen Co. Ltd.* v. *Tyson,* 26 Acct. L.R. 13 (1900) (Irish C.A.).

[61] The Appellate Division of the Supreme Court of the State of New York expressly rejected this position taken in the dissenting opinion of the court. *Craig* v. *Anyon,* 212 App. Div. 55, 208 N.Y. Supp. 259 (1st Dept. 1925), aff'd 242 N.Y. 569 (1926).

[62] See *Ultramares Co.* v. *Touche,* 255 N.Y. 170, 179 (1931).

[63] *Cereal Byproducts Company* v. *Hall, et al.*, 132 N.E. 2d 27 (App. Ct. Ill. 1956), aff'd 155 N.E. 2d 14 (Sup. Ct. Ill. 1959); 147 N.E. 2d 383 (App. Ct. Ill. 1958), aff'd 155 N.E. 2d 14 (Sup. Ct. Ill. 1959).

[64] See also *In the Matter of Monroe Loan Society,* 3 S.E.C. 407 (1938).

doctrine of contributory negligence, reached the same result first reached in the United States by means of the application of that doctrine.

The applicability of the doctrine in the United States was rather early limited by requiring that the public accountant demonstrate that his client's negligence in some way directly contributed or influenced the manner in which he conducted his examination.[79]

The facts in these cases generally involved reliance by the public accountant on a so-called "trusted employee" of the client. In order to establish the existence of contributory negligence the public accountant must show that he relied on such employee with the express consent and authorization of management of the client. In addition, the representative of management giving such authorization must be in a position to do so and the burden of determining whether such authority exists is on the public accountant. Recently this statement of the applicability of the doctrine has been reaffirmed. However, in another case it seems to have been somewhat broadened.

In the *Cereal Byproducts* case, the court rejected the defense of contributory negligence on the ground that the public accountant did not have the proper authorization from a responsible member of the management of the client to permit reliance on the defalcating officer-bookkeeper-stockholder.

However, in the recent case involving the Baltimore Federal Credit Union, the court stated, although its opinion did not depend on its statement, that the officers of the plaintiff had been guilty of negligence and that their failure to perform their duties in safeguarding the credit union's assets had been the inducing cause of the loss. The court stated that the credit union had not and, indeed, could not in the circumstances rely on the examiners and that the examiners had not and could not be expected to assume the obligations of the management with respect to the protection of the credit union's assets. The court also noted that the management of the credit union had failed on numerous occasions to follow the advice and suggestions of the examiners with respect to maintaining members records. While this does not represent a complete return to the earlier cases applying the doctrine, it does serve to place the primary responsibility for protection of assets on the management.[80] To this extent this court appears to have adopted the more rational view followed by the English and Canadian courts.

Both of these cases, as well as the earlier cases, point up the necessity of determining which employees of a client are authorized to speak for management. All too often in the course of an examination, the junior and some senior representatives of the public accountant rely on individual employees where such reliance is completely unjustified.

These cases also point up the necessity for the public accountant making adequate records as to not only whom he relies on but also where the authorization for such reliance originated.

There is another troublesome situa-

[79] *National Surety Company* v. *Lybrand*, 256 App. Div. 226, 9 N.Y.S. 2d 554 (1st Dept. 1939).

[80] *Social Security Administration, Baltimore Federal Credit Union* v. *United States*, note 66, *supra; Craig* v. *Anyon*, note 77, *supra; In re S. P. Catterson & Sons Ltd.* [1937] 81 The Acct. L.R. 62; *International Laboratories* v. *Dewar* [1933] 3 D.L.R. 665 (Manitoba Court of Appeal).

tion which most often occurs in the case of small or medium-size clients, with systems of internal control which are inadequate. The Institute has recently reiterated, in Statement on Auditing Procedure No. 29, the long-standing position of the profession to the effect that lack of an adequate system of internal control requires the expansion or change in timing in the application of the audit procedures. Implicit in this statement is the conclusion by the Committee that such expansion or change in timing is necessary for reasonable assurance that to the extent defalcations could, in the judgment of the public accountant, affect the fairness of the statements, the possibility of such defalcations going undiscovered is minimized. Such alteration of procedures raises the problem of either persuading the client that such procedures are necessary and therefore worth the additional cost or impressing upon him the danger of assuming the risk for the failure to permit such alteration. This is not to say that there is not a minimum alteration of procedures which may be necessary in order to permit the issuance of a clean short-form report. How far the public accountant fails to go or must go in this regard must be left to his professional judgment. His only protection, however, from the client who may, in the exercise of hindsight, go further, lies in the clear understanding with his client, adequately recorded in the public accountant's own records, that the client has assumed the risk for the failure to alter procedures. It must be made clear that the client cannot abdicate his responsibility for the protection of assets.

It may be argued that the very failure on the part of the client to permit an extension of procedures forecloses a later contention by the client that he relied on the public accountant for the detection and disclosure of a defalcation. It may be helpful in this connection to inform the client who is sophisticated in accounting matters just what the omitted or eliminated procedures entailed and their specific purpose.[81]

A further problem exists in the cases of corporations which are owned, at least in part, by stockholders who do not represent the management. May not the public accountant have an obligation to these absentee owners which he cannot escape in all cases by pleading reliance on management and its judgment or representations?[82] Expressed another way, there may be cases where the public accountant cannot, because of the circumstances, rely upon the judgment or representations of management when in the exercise of his own professional judgment management's position is unwarranted, and represents no more than a gamble by management, if not something worse.

DAMAGES RECOVERABLE IN THE CASE OF AN UNDISCOVERED DEFALCATION

The early cases appear to have held that the monetary loss resulting from an undiscovered defalcation was not the damage contemplated by the parties to the contract.[83] The more recent cases have recognized that if the failure to exercise reasonable care resulted in a loss by virtue of a defalcation that the plaintiff client is entitled to a recovery

[81] See *White* v. *La Due,* 118 N.Y.S. 2d 928, 932 (Sup. Ct. Monroe Co. 1950).

[82] See, *Flagg* v. *Seng,* 16 Cal. App. 2d 545, 60 P. 2d 1004 (1936).

[83] *Board of County Commissioners of Allen County* v. *Baker,* 152 Kan. 164, 102 P. 2d 1006 (1940); *City of East Grand Forks* v. *Steele,* 121 Minn. 296, 141 N.W. 181 (1913).

based on the amount of the defalcation.[84] If it is a fact that the public accountant has an obligation to do a certain amount of work designed to detect and disclose defalcations then the client must have the right to recover for defalcations not discovered when the public accountant has not done that amount of work. The extent to which a client has relied on the public accountant for the detection of defalcations may also have some bearing not only on the question of liability in the abstract but on the measure of damages. A client whose own records demonstrate either duplication of that portion of the work done by the public accountant aimed at the detection of defalcations or simply non-reliance on the public accountant for such detection can hardly be heard to claim injury on account of any such non-discovery.[85]

The concluding episode of the *Cereal Byproducts* case[86] affords some comfort to the public accountants since it holds that defalcations which occurred prior to the conclusion of the first engagement and undiscovered during the course of that engagement are not recoverable on the grounds that a recovery against the defalcating employee would be too highly speculative. However, this same case goes on to hold that future defalcations by the same employee are recoverable since they would have been prevented had the original defalcations been discovered.

The same case has a holding which may develop as a mixed benefit to the public accountant profession. The case holds that, where the defalcation was effected by forged endorsements, amounts recovered from the bank by the client are to be offset against the recovery available from the public accountant. Since virtually all of the banks are covered by bonds, which in most cases will not have been written by the same companies as those writing the public accountant's professional liability insurance policies, it may reasonably be anticipated that the banks will resist making payments and defend on the merits, seeking to join the public accountants in any actions against them. The theory of such a joinder may be that the banks are entitled to the protection of the audit as third-party beneficiaries or that the bank is no more than a joint tort feasor with the public accountant, entitled to contribution in the event of a recovery by the client.[87] While it is highly doubtful that either theory is sound, they may serve to discourage the banks or their bonding companies from making settlements and will in all probability increase the incidence of actions commenced against public accountants in such circumstances.

LIABILITY RESTING ON A SPECIAL-PURPOSE CONTRACT

At the outset, it should be repeated that breach of a contract to perform a specific task such as detecting defalcations or filing a timely claim for the refund of taxes, is, from the point of view of a plaintiff, far simpler to establish than is the failure on the part of a public accountant to exercise reasonable care.

The advantages of a letter of engagement spelling out the scope of an examination are self evident. However, implicit in the use of such letters is the danger that they may be construed to impose an obligation

[84] See, e.g., *Cereal Byproducts Company* v. *Hall, et al.*, note 63, *supra; National Surety Company* v. *Lybrand*, note 79, *supra.*

[85] See note 81, *supra.*

[86] 147 N.E. 383 (App. Ct. Ill. 1958) aff'd 155 N.E. 2d 14 (Sup. Ct. Ill. 1959).

[87] See, e.g., *Hutton* v. *Holmes*, 97 Cal. 208, 31 Pac. 1131 (1893); *Wolf* v. *Title Guarantee & Trust Co.*, 251 App. Div. 354 (1st Dept. 1937).

which was not intended to be undertaken by the particular public accountant.

A recent case is illustrative of this proposition.[88] A letter was written by the public accounting firm which in general terms stated that the purpose of the examination was to render a short-form opinion on the statements of the client. The language used in the letter to describe the engagement was substantially the same as that contained in the scope paragraph of the short-form report. However, in describing the scope of the examination and the report to be rendered, the public accountants stated, in part, that they would follow "the same procedures" as in past years. A motion was made by the defendants to dismiss the claims relating to the defalcations which occurred more than three years prior to the commencement of the action on the ground they were barred by the negligence statute of limitations. The court denied the motion stating that the use of the words "same procedures" raised a question of fact as to whether the particular contract involved was one which imposed upon the public accountant the obligation of following the "same procedures" or whether it was simply precatory language in an overall agreement to conduct an ordinary examination leading to the rendition of a short-form report. The court recognized that if the latter were true the three-year negligence statute of limitations would be applicable rather than the six-year contract period.[89]

In a case decided quite recently a similar argument on behalf of the defendants prevailed.[90] The entire action was dismissed on the ground that the plaintiff could not escape the strictures of the statute of limitations as applied to negligence actions by attempting to frame his complaint in the form of a contract claim, when his claim was, in substance, for negligence.[91] The court went one step further and stated that it was immaterial that the complaint also alleged fraud which was subject to the same period of limitation as the contract action. The basis for this conclusion was that the allegations of fraud were simply allegations of gross negligence rather than fraud resting on an express intention to deceive. Only the latter type of fraud was considered subject to the fraud period of limitation with actions sounding in gross negligence being subject to the ordinary negligence period of limitation.

Where allegations have been made of a simple breach of contract, the courts have not been hesitant to decide the case on the simple propositions of contract law and so determine whether there was or was not performance under the terms of the contract.

In a somewhat older case[92] which illustrates the importance of care in drafting engagement letters, the court rejected, in a trial on the merits, what

[88] *Essley Shirt Company, Inc.* v. *Lybrand,* 285 App. Div. 1044, 140 N.Y.S. 2d 12 (1st Dept. 1955).

[89] The court was not impressed by the argument that a public accountant would clearly be guilty of a breach of his professional obligation in an engagement leading to the rendering of a short-form report if he were to agree to, and follow, the "same procedures." See, 40 Questions and Answers About Credit Reports (answers to questions bankers are likely to ask about CPA audits and audit programs), p. 10 (AICPA 1956).

[90] *Peerless Casualty Company* v. *John F. Forbes & Company,* Civil Action No. 36494 United States District Court (N.D. Cal. 1957).

[91] A very recent case decided in New York reached exactly the same conclusion; *Carr* v. *Lipshie,* 142 NYLJ page 1, Col. 8, July 22, 1959 (App. Div. 1st Dept.).

[92] *Maryland Casualty Co.* v. *Cook,* 35 F. Supp. 160 (E.D. Mich. 1940).

it considered to be the sophistry of the expert witnesses called in behalf of the defendants who attempted to limit the scope of the defendant public accountants' responsibility in terms of the type of audit involved, stating:

> I think it is high time for accountants to know that if they want a particular contract which they enter into to be measured in the technical terms of a cash audit, or a balance sheet audit, or a detailed audit, they should insist that their contract and specifications, which they agree to comply with in their contract, should plainly state the facts.

In this particular case the court had no hesitancy in concluding that the public accountants had been negligent as a matter of law in the performance of their contract obligation. It should be noted that, ordinarily, the meaning intended by the parties to be given to a contract is a question of fact for the trier of facts.[93]

Some of the other older cases are also interesting in this regard since they demonstrate the difficulty caused by loose language in drafting either letters of agreement or specifications for audits of municipalities.[94] These latter situations are fraught with problems since the specifications are all too often drafted by laymen or by lawyers who are not fully aware of what the public accountant can or cannot be expected to do or accomplish during the course of an audit. The public accountant in such a situation should proceed no further until he has clarification of his undertaking lest he find himself in the position of, without knowing it, having undertaken to detect and disclose defalcations.

Engagements which are by their nature limited in scope, such as engagements for the preparation of statements from books and records only, should be the subject of a written contract. Without such a contract and/or a history of prior performance of such a limited type examination, liability may well result.[95] While there have been no cases to date where the courts have felt constrained, or been able, to rely on Statement No. 23, there can be no question that such financial statements should carry the legend required by Statement No. 23 (e.g., "prepared from the books without audit").

There are, of course, a few isolated cases where the public accountant has undertaken specific, and what he considered limited, obligations. The simple breach of these obligations has resulted in actions for the failure to properly determine the tax basis of stock,[96] for the failure to properly determine the value of a stockholder's investment in an appraisal proceeding,[97] and the failure to make a timely filing of income tax returns.[98] These cases add little to the general law of accountants' liability since they stand simply on the ground of the failure to perform an obligation specifically undertaken.

LIABILITY TO THIRD PARTIES

It is the prospect of possible liability to third parties in connection with reports on statements prepared or submitted by clients for credit pur-

93 *O'Neil* v. *Atlas Automobile Finance Corp.,* 139 Pa. Super. 346, 11 A. 2d 782 (1940).

94 *Board of County Commissioners of Allen County* v. *Baker,* 152 Kan. 164, 102 P. 2d 1006 (1940); *City of East Grand Forks* v. *Steele,* 121 Minn. 296, 141 N.W. 181 (1913).

95 *O'Neil* v. *Atlas Automobile Finance Corp.,* note 93, *supra.*

96 *Rassieur* v. *Charles,* 188 S.W. 2d 817 (Mo. 1945).

97 *Gammel* v. *Ernst & Ernst,* 72 N.W. 2d 364 (Sup. Ct. Minn. 1955).

98 *L.B. Laboratories* v. *Mitchell,* 39 Cal. 2d 56, 244 P. 2d 385 (1952).

poses which has caused the profession the most concern in recent years.

Basically, it is the opinion of the public accountant which, in the mind of the third-party lender, gives credence to such statements. In any review of a prospective borrower's financial statements it is well recognized by the courts that the statements themselves are the factual representations of the client and that the public accountants represent only that they have an opinion with respect to those representations.[99] In the eyes of the lay public, however, this nice distinction, if recent cases are any indication, is lost if not ignored.

TWO THIRD-PARTY GROUPS

Third parties to whom public accountants may be liable generally fall, on the basis of the decided cases, into two groups. The first group consists of those third parties to whom statements are furnished where the public accountant has knowledge that the statements are prepared primarily for the benefit of such parties. In these cases the public accountant is probably liable for simple negligence as distinguished from fraud. A recent case which resulted in the affirmance of a judgment entered on a jury verdict for the defendant public accountant so stated by way of dictum.[100] This dictum would appear to be consistent with the prior law. However, an English court recently concluded that the public accountant was not liable for negligence even where he knew that the report was prepared for the primary benefit of the third-party lender.[101] It would seem highly unlikely that this ruling will be adopted by the courts in the United States. The growth of the law of negligence in areas other than the narrow one of accountants' liability certainly points in this direction.

The question of whether a report is prepared for the "primary benefit" of a particular third-party lender is a question for the trier of facts. It might be well for the public accountant in cases where he is aware that reports prepared by him are to be submitted to creditors to establish in his records that the person for whom the report is being prepared is the client and it is only an incident of such performance that the statements are also being made available to creditors.

The public accountant may also be liable to third-party lenders in cases were the statements are not prepared for the primary benefit of such lenders but where he is aware that the client intends to make use of the statements for credit purposes to a group of lenders of which a particular lender is a member. The cases hold generally that in order for the public accountant to be held liable to this group, the trier of the fact must find that the public accountant was guilty of fraud.

FRAUD AND GROSS NEGLIGENCE

The problem of identifying the meaning of the word "fraud" in this context has caused considerable confusion. Obviously, if there has been an affirmative and deliberate concealment of facts which is intended to mislead and conceal there can be no question as to liability.

The cases, however, go one step further and state that the trier of facts may conclude that fraud exists, where the accountant's opinion on his client's statement is based on an ex-

[99] See note 59, *supra*.

[100] *C.I.T. Financial Corp.* v. *Glover*, 224 F. 2d 44 (2d Cir. 1955).

[101] *Candler* v. *Crane, Christmas & Co.*, 2 KB 164, 1 The Times L.R. 371 (Ct. of App. 1951).

amination so grossly inadequate that it would not only preclude a reasonably prudent public accountant similarly situated from expressing such an opinion but also would permit an inference by the trier of facts that the grounds supporting such an opinion were so flimsy that the public accountant had no genuine belief on which to base his opinion.[102]

The fraud, then, which has given rise to the reported cases commenced by third parties is based on gross negligence. It differs from simple negligence, which may give rise to liability to clients or the third parties identified above, only as a matter of degree. Whether negligence is "simple" or "gross" is a factual question which must be left to the trier of facts.

EXPRESSION OF OPINION AND REPRESENTATION OF FACT

Much has been written with respect to the difference between an accountant's expression of opinion on financial statements and his representation that certain financial information is true and accurate. Here again, the distinction, although a valid one, seems to have caused substantial confusion. It is just as much a statement of fact for an accountant to say that he has an opinion with respect to financial statements as it is for him to represent that the financial statements are true and accurate. Just as his belief that the statements of fact in the financial statements were true does not protect him from liability, so too his belief that his opinion is justified does not protect him from liability. In both situations his belief must be an honest one.

In each case, if the auditor had no basis for his statement because of his failure to follow recognized audit procedures applicable in the circumstances, the trier of facts may infer that he did not care whether his statement was accurate and so was guilty of fraud. In short, he will be held liable in the event the trier of facts concludes that he either expressed his opinion or made a statement of fact with reckless disregard of whether the work done justified such statement.[103]

The significance of the difference between an expression of opinion and a representation of fact is that in order for the public accountant to have a genuine belief in the truth of the latter he must have done a quantum of work far beyond that contemplated as the scope of an ordinary examination for the purpose of expressing an opinion on a client's representations of fact contained in the client's financial statements.

THIRD-PARTY RELIANCE

It is not the purpose here to set out a detailed analysis of the early cases which gave rise to the third-party liability of public accountants since they are discussed at length by Mr. Levy in his book. One point which is worthy of note is the question of reliance by the third-party lender on the accountant's report. It is the rule that in order for a third party to recover where allegations of fraud are made, he must show reliance on the fraudulent statements to his detriment. However, it is also the rule that he need not show that he relied on the statements to the exclusion of all other information available to him. If there was reliance in some degree and that

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[102] See, e.g., *Ultramares Corp.* v. *Touche*, 229 App. Div. 581, 243 N.Y. Supp. 179 (1st Dept.) rev'd 255 N.Y. 170 (1931); *State Street Trust Co.* v. *Ernst*, 278 N.Y. 104 (1938); *O'Connor* v. *Ludlam*, 92 F. 2d 50 (2d Cir.), cert. denied 302 U.S. 758 (1937).

[103] *Duro Sportswear, Inc.* v. *Cogen*, 131 N.Y.S. 2d 20 (Sup. Ct. N.Y. Co. 1954), aff'd without opinion, 137 N.Y.S. 2d 829 (1st Dept. 1955).

reliance was one of the inducing causes of the lender's damage, he is entitled to recover.[104] The measure of damages in these third-party cases is generally the amount of the loan to the extent not repaid by the borrower.[105]

The recent *C.I.T.* and *Bank* cases do not establish any new principles of law but do serve to illustrate the problems which the profession faces where claims against its members are litigated. These two cases, one tried in the Federal court and one tried in the State court, involved exactly the same set of facts and the same report. One resulted in a jury verdict for the defendants and the other in a jury verdict for the plaintiff. Both of the cases were affirmed on appeal although there were substantial differences between the charges given to the juries by the trial judges on the meaning of what the defense alleged in both cases represented a disclaimer, as was pointed out in the first half of this article.[106]

CONCLUSION

The public accountant's legal liability is not yet, and probably never will be, subject to precise delineation. As the profession clarifies its own thinking and as it grows and moves into new fields, the areas as well as the theories of liability may change. The only conclusion possible at this stage of the development of theories of liability is that a public accountant exposes himself and his most important asset, his professional reputation, to injury where he fails to recognize and observe the generally accepted standards of performance established by the profession.

[104] See *Ochs* v. *Woods,* 221 N.Y. 335 (1917).
[105] See note 102, *supra.*
[106] Compare *Beardsley* v. *Ernst,* 47 Ohio App. 241, 191 N.E. 808 (1934).

Financial Transactions Between Staff and Clients

All firms, however, look askance at any kind of financial transactions between staff and clients. Some dealings may be forbidden even if the staff man performs no services for the client. Thus, a financial interest in the business of any of the firm's clients may make it necessary to dismiss the employee. Borrowing of money from clients, contracting of debts and purchasing of merchandise at a discount or at cost may be permitted if the accountant does not perform any services for the client. Even the simple cashing of personal or salary checks violates the rules laid down by some firms. The best policy for the accountant is to ask the senior in charge or the principal if he is not certain as to the firm's policy or reaction. Unwillingness on the part of the staff man to inquire may indicate doubt as to the propriety of the action.

Practice Management Forum, "Relationship Between Staff-Accountant and Client," The Report (Colorado Society of CPAs), May 1959

Acquisition of Motels

By HOWARD W. HOGG, CPA

This article discusses the accountant's role in the preparation of financial analyses and forecasts for a client who is contemplating the acquisition of a motel. Appropriate differentiation as to approach is made as between purchase, construction or leasing of properties and general guides are stated for evaluating the reasonableness of the purchase price.

THE acquisition of a business is an important step whether it involves a large corporation acquiring an additional division or unit, or an individual acquiring a small one-man operation. The acquisition of a motel or motor hotel is no exception. It may even be more important to the principals involved because in many cases motels are operated by small businessmen and their acquisition may require the investment of a man's life savings and represent his principal security for the future. For this reason, it is imperative that the prospective investor have as much information available as possible upon which to base his decision to buy and to invest his money. One of the important ways in which the accountant can be of assistance is in the preparation of financial analyses and forecasts and in the rendering of financial advice prior to acquisition.

There are various ways in which the prospective investor may enter or expand in the motel business. He may plan to purchase or lease a motel already in operation, or lease or build a new motel property.

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ANALYSIS OF EXISTING OPERATIONS

Where an existing property is to be purchased or leased, there should be considerable information available. Since the property has been in operation, the accountant should be able to obtain and review not only the most recent financial statements and operating statistics but also those applicable to prior periods. Profit and loss statements should be obtained and carefully reviewed and the composition of the various income and expense accounts should be determined. For example, analyses of administrative, advertising and repair and maintenance expense accounts may reflect abnormal conditions and furnish information that will be helpful in the preparation of forecasts of future operations. The ratios of the various expense accounts to income should be computed and compared with existing trade statistics. For example, TOURIST COURT JOURNAL, a national magazine, publishes an annual study which shows the operating statistics of smaller motor courts not only for the country as a whole but also

broken down as to regions. Statistics are also compiled for the larger motor hotels by those accounting firms specializing in the industry. All of these statistics are, of course, averages obtained by combining operations of many properties and there may be valid reasons why those for the operation under study may differ. However, any wide variances should act as a red flag and be the subject of further investigation to ascertain the reasons.

Other operating statistics, such as percentage of occupancy, average daily rate per rented room, average daily rate per guest, ratio of food sales to room sales, and ratio of beverage sales to food sales, to name a few, should also be obtained, where applicable, and compared with published information. Percentage of occupancy is obtained by dividing the number of occupied rooms during the period under review by the total number of rooms available. The computations of the other statistics mentioned are self-explanatory.

In addition to comparing the motel's percentage of occupancy with published statistics, it is also advisable to compare it with the percentage of occupancy computed as necessary for the motel to "break-even." A high "break-even" occupancy percentage and a slim margin between it and the actual occupancy percentage might indicate a marginal operation that could easily turn into a loss. A comparison of the average daily rate per rented room should also be made with the rates charged by other operators in the area to determine whether rates charged are competitive.

If the enterprise includes a restaurant or coffee shop, its operations should be reviewed. A determination should be made not only as to whether it is contributing profits but also whether the profits are reasonable. Food, beverage and other cost ratios should be obtained and reviewed for clues to possible operating inefficiencies. Food and beverage cost ratios will vary depending upon the type of restaurant and the type of food and beverages sold. However, a food cost of approximately 40 percent of food sales and a beverage cost of approximately 35 percent of beverage sales may generally be regarded as reasonable standards in appraising the restaurant operation.

In the review of operating results and statistics, the accountant should be continually alert for trends, both favorable and unfavorable, and for items that may lend themselves to improvement in the future. He should also determine whether the business is seasonal since this may have an effect on future planning.

Sometimes the seller reveals very little other than current operating statements which may or may not be complete and accurate. This is particularly true of smaller operations. The appraisal of such statements is a function that falls almost entirely upon the accountant. Reference to the seller's tax returns, if they are made available, may be helpful in such cases.

If the operation is a large one, information should be obtained concerning the employees. Number of employees, adequacy and competency of staff, details of labor agreements, if any, and data on personnel policies are some of the items to be investigated. Such information is particularly important if the purchaser does not intend to manage the property himself.

FORECASTS

Forecasts of future operations and of future cash requirements and cash availability should also be prepared by the accountant. Generally such forecasts should be prepared on a monthly basis for the first year at least and on

an annual basis for future years insofar as changes in results can be anticipated.

Forecasts of operations may be based on past experience but should reflect the anticipated results from any contemplated changes to be made, such as renovations, new advertising and promotional policies, new facilities to be added and the correction of any presently existing operating inefficiencies.

There will, of course, be no historical data to review on past operations for properties not yet in operation, and forecasts for such properties require considerably more crystal-ball gazing. Forecasts should nevertheless be prepared, and it should be remembered that it is always wise to be generous in estimating expenses and conservative in estimating income. In a new operation it is generally not prudent to expect occupancy and sales to reach desired levels from the outset. It takes time to build up any business, and motels are no exception.

Cash forecasts based on both operating forecasts and present and proposed lease and debt commitments are a "must." Through their use it can be determined whether or not cash will be available when needed for the payment of operating expenses and debt commitments. If the business is seasonal in nature, monthly forecasts are particularly important since the cash "throw-off" on a yearly basis may not be available at the particular time during the year when a specific mortgage or other payment must be made.

PURCHASE CONSIDERATIONS

If the investor is planning to purchase the property or business, the proposed transaction may require the purchase of assets or it may require the purchase of stock of a company. In either event, the tax consequences of the proposed transaction should be thoroughly explored, not only from the buyer's point of view but also the seller's. Many transactions are dependent to a large degree on the tax results and the accountant can frequently render invaluable service in this area. For example, a slight recast of terms may give the seller the advantage of reporting the transaction as an installment sale for tax purposes. The buyer, on the other hand, might benefit from the inclusion in the purchase agreement of an allocation of the purchase price to the assets purchased. Other matters to consider might be whether to incorporate the business or not, utilization of loss carry-overs and future depreciation policies.

If the property is to be acquired by purchase of a corporation's capital stock, it will be necessary to determine that all assets have been stated fairly and all liabilities have been included in the corporation's balance sheet. If the statements have been examined by a certified public accountant, they will obviously be more creditable; and the CPA himself will probably be an excellent source of additional facts and data. In many cases items that are not in the statements may be extremely important and require complete investigation. For example, a thorough review of the company's tax returns and tax status should be made to determine which years are still subject to review by the Revenue Service, and possible causes for additional tax assessments. Contingent liabilities, lawsuits and liens are other troublesome items which should be investigated thoroughly and, if possible, covered by indemnification provision in the purchase agreement.

The purchase price should be weighed carefully to determine whether it is reasonable in view of the expected return on the investment. In computing the return on investment two fac-

tors should be included—interest on the capital to be invested and compensation for the time to be devoted. Capital to be invested should include not only the initial purchase price but also any investment to be made in working capital, renovations, additions and alterations. Time to be invested would be the owner's time if he intends to operate the business himself.

There are a number of general tests that can be made with regard to the purchase price. Again, as in the case of published operating statistics, it should be emphasized that they are merely yardsticks and must be considered as nothing more. Each transaction must of necessity be considered and made on its own merits. It has been said, for example, that as a rough rule of thumb the purchase price of a small motel should generally be approximately three times the annual room sales, and the price per room should be in the neighborhood of $800 for each $1 of average room rate. The latter guide will vary depending upon the facilities offered and upon the ratio of room sales to total revenue. For example, if a 20-room motel with an average room rate of $7 and an occupancy percentage of 70% were under consideration, these yardsticks would produce the following figures. Annual room sales would be approximately $35,770 computed as follows: 365 (days) x $7 (rate) x 20 (number of rooms) x 70% (occupancy percentage). Three times the annual rooms sales would amount to $107,310. On the other hand, the average room rate ($7) times the number of rooms (20) times $800 would amount to $112,000. If the guides are correct the price would be in the neighborhood of $110,000. A further check of the purchase price would be its comparison with the estimated costs of reproduction less depreciation as reflected by an appraisal of the property.

Financing arrangements must also be considered. Does the investor intend to seek a new mortgage or assume an existing mortgage? Will the seller take a second mortgage on the property? The accountant can again be of help in preparing financial information for the bank or lending agency. Most of the analyses and forecasts mentioned above will be helpful in this respect.

The purchase agreement when drawn should also be reviewed carefully by the accountant before it is executed to see that all conditions and terms, having financial and accounting significance, that have been agreed to by the parties have been included correctly.

LEASE CONSIDERATIONS

If the property is to be operated under lease the accountant should study carefully all the terms of the proposed lease. The rent provision is particularly important since it may call for rent to be computed in one of a number of ways. Rent may be stated as a fixed amount, as a percentage of revenues or profits, or in a minimum amount to which a percentage of revenues and/or profit is to be added. In a percentage-rent arrangement the landlord will normally insist on a somewhat higher potential rent since he is, in effect, assuming some of the risks of the operation. Although all possibilities should be considered, the best method to use will vary depending upon the facts in the individual circumstance.

The lease should be written in such a way that it can be interpreted with certainty accounting-wise. If rents are to be based on revenues or profits, the items to be included in their determination should be clearly speci-

fied. The lease should indicate not only whether the landlord or the tenant is to pay for insurance and property taxes, but also the insurance coverage to be maintained and what adjustment, if any, may be made in the rents in the event of an increase in property taxes. If repairs and maintenance costs are to be paid for by the tenant it may be desirable to specify minimum annual amounts to be expended to avoid misunderstandings between the parties at a later date. The disposition of inventories and supplies and items of prepaid and accrued expense at the dates the lease becomes effective and terminates should also be covered. Leases frequently specify that the amounts applicable to such items are to be determined by the accountants. As mentioned previously, all the terms of the proposed lease should be carefully reviewed, the pros and cons of fixed rents versus percentage rents should be considered and the entire matter weighed as to whether or not it is a good deal in the circumstances.

In the final analysis the agreement must be such that both parties can expect to live with it. The landlord must receive enough rent for his property to enable him to meet his commitments and show a fair return on his investment. The lessee on the other hand should be able to realize operating profits sufficient to compensate him for his investment.

CONSTRUCTION CONSIDERATIONS

If the property is to be constructed, the accountant can help his client in accumulating estimates of the various costs of land, building, furniture and equipment. Costs of these items should bear some reasonable relationship to each other. An expensive building with poor furnishings will be no more attractive to a guest than a poor building with expensive furnishings. A rough rule, sometimes quoted, is that of the total investment the cost of land should equal 10 percent, the cost of buildings should equal 70 percent, and the cost of furniture and equipment should equal 20 percent. Costs of a particular property will undoubtedly vary somewhat depending upon its location and the facilities to be offered. Land within or close to a city will in all likelihood cost more than land on the open highway between cities. In this connection, consideration should be given to the possibility of building on leased land in order to reduce the total investment. Building costs will be affected not only by costs in the area but also by requirements imposed by climate, local ordinances and the facilities to be included. Furniture and equipment costs will be greater for a motel with restaurant facilities than for one without.

Other matters which may require the accountant's attention are the review of construction contracts, the preparation of data for negotiations for construction loans and permanent financing and the preparation of cash forecasts during the construction period.

In the final analysis it can be seen that the financial considerations necessary in the acquisition of a motel or motor hotel are not completely different from those involved in the acquisition of other types of business. The approach, however, is somewhat different because of the specialized nature and peculiarities of this particular type of business. The client in any case should be helped in the development and review of financial facts and other information with respect to the past, present and future, in order that he may determine whether it is feasible from a business standpoint for him to invest in the property under consideration.

Officers' Compensation in Closely-Held Corporations

By BERNARD BARNETT, CPA

The officer-stockholder of a closely-held corporation is concerned both with the adequacy of his compensation and its deductibility by the corporation. The Treasury Department, on the other hand, is primarily concerned with preventing the payment of dividends in the form of compensation to shareholders. This article reviews the income tax problems encountered in utilizing the various forms which officer compensation may take in closely-held corporations, including salaries, fringe benefits, deferred payment plans and salary continuance payments to widows.

INTRODUCTION

WHEN dealing with officer compensation problems of closely-held corporations, we enter a field fraught with controversy between the corporation and its officer-shareholders on one side and the Treasury Department on the other. One of the prime concerns of the officer-shareholder is the adequacy of his remuneration and its deductibility by the corporation. The Treasury Department, on the other hand, is primarily concerned with preventing the payment of dividends in the form of compensation to shareholders.

Compensation paid to officers of closely-held corporations can take many forms. Payments can be termed salary, bonus, commissions or can be in the form of fringe benefits or deferred payment plans. Whatever called, it is, of course, essential that the aggregate compensation payments be able to meet the all-important test of deductibility by the corporation. It is here that we meet that great stumbling block of "reasonableness" which has resulted in much controversy between taxpayer corporations and the Treasury Department.

REASONABLENESS OF COMPENSATION

The Internal Revenue Code permits a deduction under Section 162(a)(1) for "a reasonable allowance for salaries or other compensation for personal services actually rendered." I

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will not attempt to set forth here the criteria established in the numerous cases touching on this point. These criteria as established in the pertinent court decisions have been the subject of exhaustive analyses and publicity. These decisions usually boil down to a question of fact, to be determined in each case; every tax service contains statistical tables of illustrative cases by industries and types of business.

In a closely-held corporation, we may presume an attack by the Treasury Department on officer-stockholder compensation. In such event the Internal Revenue Service comes into the battle armed with its terrible weapon—the burden of proof is with the taxpayer. The determination of the Internal Revenue Service is presumed correct; the taxpayer must prove to the contrary. One fundamental question peculiar to closely-held corporations is whether the payment is made for services actually rendered or whether there is an intent to distribute profits in the form of compensation in order to minimize or eliminate any income tax liability of the corporation and avoid the "double tax" on dividends. Thus, the Regulations (Sec. 1.162-7 (b)(1) provide that:

> Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, particularly all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

WHAT IS REASONABLE?

The Regulations (Sec. 1.162-7 (b)(3)) state that: "It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." When dealing with the problem of reasonableness of compensation to officer-shareholders of closely-held corporations, the courts have weighed such factors as the omission of or failure to increase dividends in a period of rising income (*Amco Investment Co.,* 4 TCM 307 (1945)); have given great weight to evidence of amounts paid for like services by like enterprises in like circumstances (*Builders Steel Co.,* 8 TCM 296 (1949), aff'd 197 F. (2d) 263 (1952)); and have tended to ignore or give little weight to resolutions of stockholder-controlled board of directors (*Glenshaw Glass Co., Inc.,* 5 TCM 864 (1946), aff'd 175 F. (2d) 776 (1947), cert. denied 333 U. S. 842 (1948)). "No single factor is decisive. It is the interplay of several factors that must be weighed. . . ." (*85 Es Realty, Inc.,* D. C., So. Dist. N. Y., 12/31/58).

The Internal Revenue Service does not appear to use any percentage rule of thumb in determining the reasonableness of the salary of an officer-stockholder. As in the case of all general statements there is perhaps one exception and that pertains to the reasonableness of compensation of officer-stockholders of closely-held real estate corporations. In such cases it is evidently the *unofficial* rule of thumb (of agents working out of New York City) to allow a maximum of 10 percent of the rent income as officers' salaries, and that only where the officer actually manages the property (i.e., no managing agent is used).

The Code imposes an additional limitation which is particularly pertinent to salary payments, etc. made to officer-stockholders of closely-held corporations, even though reasonable.

Section 267 of the Code disallows a deduction for salaries paid to an employee who owns directly or indirectly more than 50 percent of the paying corporation's outstanding stock where payment is not made within two and one-half months of the close of the year by the accrual-basis paying corporation to the stockholder-employee who reports on the cash basis.

PERCENTAGE COMPENSATION

Arms-length and long-standing plans involving a percentage basis for determining compensation have been recognized by the courts as establishing reasonable compensation. Such plans, which are generally based on a fixed percentage of gross income or net profits, must, however, have been entered into before the services are actually rendered (Reg. Sec. 1.162-7(b)(2)). The reasonableness of a contract for percentage compensation is to be determined primarily in the light of the circumstances that existed when it was made and it is usually immaterial that in the actual working out of the contract the contingent compensation may prove to be greater than the amount which would ordinarily be paid (*California Vegetable Concentrates, Inc.*, 10 TC 1158 (1948), Acq.; Reg. 1.162-7(b)(2)). It should be noted, however, that the existence of such a plan, while not conclusive in the case of closely-held corporations, is a factor which usually receives favorable consideration particularly where it has been in effect during "lean" as well as "fat" years (*Madison Silo Co.*, 11 TCM 82 (1952)).

It is also possible for a closely-held corporation to pay in the current year additional salary or bonuses for services rendered in prior years, provided that the total compensation paid for each of the prior years, including the additional payments made in the current year, are reasonable in relation to the services rendered. Thus, for example, in a recent case (*Jewell Ridge Coal*, 16 TCM 140 (1957)) large bonuses paid to the corporation's chief executive were allowed as reasonable compensation for past services where evidence had been provided to show that he had been underpaid in prior years.

Whatever the basis of compensation paid by a closely-held corporation, it is highly advisable to plan and prepare to defend the reasonableness of the amount of such compensation paid before the tax examination rather than when confronting the Internal Revenue agent.

FRINGE BENEFITS

As previously noted, the Code (Sec. 162(a)(1)) permits a deduction for "a reasonable allowance for salaries *or other compensation* for personal services actually rendered" (emphasis supplied). In determining the reasonableness of compensation the Internal Revenue Service will aggregate the value of all fringe benefits directly or indirectly received by the employee together with his salary and determine the reasonableness of the total. In the case of the officer-stockholder of a closely-held corporation any amount not determined "reasonable" by the Service will be deemed a dividend.

Omitting deferred compensation plans which will be discussed later, the most common fringe benefits can be grouped as follows:

1. group term insurance, group hospitalization, health, accident and medical insurance, and sick pay plans,
2. stock options,
3. split-dollar life insurance, and
4. the various currently favored incentives such as executive dining rooms, use of company cars, town apartments, country club memberships, etc.

Let us review the special tax prob-

lems of an officer-stockholder of a closed corporation receiving each of these various types of fringe benefits.

GROUP INSURANCE PLANS

It is probable that payments made by a closely-held corporation for group term insurance, hospitalization, health, accident and medical insurance and sick pay plans would be allowed as deductions even where officer-stockholders were included in the group, provided that such plans did not inordinately discriminate in favor of the officers or stockholders. In such a case, the value of these benefits would not be taxed to the officer-stockholder, unless the amount of compensation paid such officers, including the value of these benefits, was deemed to be unreasonable.

STOCK OPTIONS

For a variety of reasons, the use of stock options is not a popular or practical way of compensating officer-stockholders of a closely-held corporation. The officer-stockholder or stockholders already control the corporation and additional stock purchases by them can add little or nothing. Moreover, the Internal Revenue Code (Sec. 421) does not permit an employee owning directly or indirectly more than a 10 percent voting stock interest in the corporation to receive a restricted stock option at the favorable price between 85 percent and 95 percent of the fair market value of the stock. To such a person the option price must be at least 110 percent of the fair market value and must be exercisable within five years (Sec. 421(d)(1)(C)). Even if the officer-stockholder wanted to come under these restrictive provisions he still must be prepared to face a battle over the always difficult determination of the fair market value of stock of a closely-held corporation.

SPLIT-DOLLAR LIFE INSURANCE

Under a split-dollar life insurance plan the employer corporation pays that portion of the annual premium equal to the increase in the policy cash value, which value is assigned to the corporation. The corporation thus actually has an investment which will eventually be repaid out of the insurance proceeds. The corporation loses nothing except perhaps interest on money representing the cash value of the insurance. It would appear, therefore, that a split-dollar life insurance plan can be effectively used for officer-stockholders of closely-held corporations.

OTHER FRINGE BENEFITS

With regard to the last enumerated group of fringe benefits—executive dining rooms, use of company cars, town apartments, country club memberships and a host of similar so-called executive incentives—it is probable that the Internal Revenue Service would take a jaundiced view where such benefits were reaped by the officer-stockholders of a closely-held corporation. Particularly if abused, it may be anticipated that the Treasury Department would try to tax the value of such benefits as dividends to the officer-stockholder recipients. Such a holding would, of course, open the possibility of a combined double tax to the corporation and stockholder exceeding the amounts deducted.

DEFERRED PAYMENT PLANS

Section 404 of the Internal Revenue Code governs the deduction allowable for payments made under pension trusts, employees' annuities, stock bonus and profit-sharing trusts and other deferred-payment or retirement plans. The use of these plans, which have experienced a tremendous growth

in recent years, can be extended, with some modification, to closely-held corporations. For discussion purposes, I will breakdown these plans into two categories: (1) qualified pension, profit-sharing and stock bonus plans, and (2) other deferred payment and retirement plans.

QUALIFIED PLANS

The use of qualified pension, profit-sharing and stock bonus plans has gained great momentum as the result of the tax benefits inserted in the law to encourage their growth. The corporation adopting such a plan gets a current deduction for all contributions, the employees pay no present tax on these contributions made on their behalf and the income earned by the trust on the amounts contributed is exempt from all income taxes.

To qualify, the plan must meet all the requirements of Section 401 of the Code. Included is the requirement which may pose a problem to closely-held corporations, that contributions or benefits provided for under the plan must not "discriminate in favor of employees who are *officers, shareholders* . . ." (emphasis supplied; Sec. 401 (a)(4).) The guides for qualification of pension, profit-sharing and stock bonus plans under 1954 Code Section 401, issued by the Internal Revenue Service as Revenue Ruling 57-163, states with respect to stockholder participants:

> Stockholders who are bona fide employees of a corporation may participate in the corporation's plan to the same extent as other employees. If, however, the plan is designed as a subterfuge for the distribution of profits to stockholders, even if it includes other employees who are not stockholders, it will not qualify as a plan for the exclusive benefit of employees. The plan must not be weighted in favor of stockholder employees either with respect to eligibility requirements or with respect to contributions or benefits. (Part 2(i)(2) of the guides set forth in Rev. Rul. 57-163.)

It is interesting to note that in *Volckening, Inc.*, 13 TC 723 (1949), the Tax Court held that the deduction of contributions to an employees' trust was not precluded by the anti-discrimination provisions of the Code even though more than 53 percent of the contributions were for the benefit of the husband and wife sole stockholders, since the contributions bore a uniform relationship to compensation, the reasonableness of which the government did not question. The Commissioner later acquiesced to this decision.

Although it is possible for a plan to qualify even though the corporation has only one employee (Part 4(a) of the guides), it is particularly difficult, although not impossible, to have such a plan approved where the only employee is a stockholder.

OTHER DEFERRED PAYMENT PLANS

The allowability of the deduction for contributions made for deferred payment and retirement plans, other than those qualifying under Section 401, are also covered in Section 404 of the Code. Thus, contributions to non-qualified trusts and plans not meeting the requirements of Section 401(a) are deductible by the employer under Section 404 if the employees' rights are non-forfeitable at the time the contribution is made. However, the employee is taxed on the amount of the employer's contribution in such a case.

Oftentimes, rather than giving an employee a salary increase, the employer may agree to defer the payment of a stated income or annuity to the employee until after retirement, for a number of years or for life. While such a plan will not normally result in additional cost to the employer, it will enable the employee to obtain substantial tax savings by receiving and including such amounts in gross income

in relatively low-income years. In return for the employer's agreement to defer the payment of such compensation, the employee normally agrees to continued employment until retirement age is reached and after retirement to a non-competition agreement and availability for consultation. Usually, endowment life insurance or a retirement annuity policy is the means by which the employer effectuates the plan. Under such a plan the employer gets no current deduction for premiums paid and the employee is not taxed on the employer's payment since any benefits he would receive are contingent on his working until retirement age and afterwards on the non-competition and consulting agreement. The employer gets his deduction and the employee is taxed only when the benefits are actually paid.

THE CASALE CASE

Can such a deferred pay plan be successfully used where the employee is an officer-stockholder of a closely-held corporation? For the answer to that question let us review the *Casale* case (*Oreste Casale,* 26 TC 1020 (1956), rev'd, 247 F. (2d) 440 (1957)).

Oreste Casale was president and a 98-percent stockholder of a corporation employing him. His daughter owned an additional 1 percent of the stock. The corporation's board of directors, which consisted of Casale, his daughter and another individual, voted Casale a typical deferred compensation arrangement. Under this agreement Casale was to receive $500 per month upon retirement for ten years certain. If he were to die after the payments had begun, but before the ten years were up, the remaining payments were to go to his named beneficiaries. If he were to die prior to retirement, the corporation agreed to pay $50,000 to his estate. Casale retained the right to change the beneficiaries of this agreement. His right to the deferred compensation payments was conditioned on a non-competition agreement and his remaining with the company until retirement. In order to fund its obligation under the agreement, the corporation purchased a combined life and annuity policy in the principal amount of $50,000 insuring his life. The corporation, the named beneficiary of the policy, paid a $6,800 annual premium which was charged to earned surplus on the corporation's books and was not taken as a deduction for income tax purposes.

The Internal Revenue Service, on examination of the corporation's income tax return, held that the payment of the insurance premium was the equivalent of a dividend to Casale. The Tax Court agreed with the Commissioner's contention, stating that the

> . . . corporation was no more than a conduit running from the insurer to the petitioner, or his beneficiaries, with respect to any payments which might come due under the insurance contract. Essentially, petitioner stood in the same relationship to the policy as if he had taken it out himself and the corporation had paid the premiums for him. . .
>
> The necessity for such a conclusion becomes more apparent when we consider the position petitioner occupied in relation to the corporation. *For all practical purposes he was the corporation.* He maintained complete dominion and control of its every move; and any future disposition of insurance proceeds would be subject to his assent and approval. (Emphasis supplied.)

The Court of Appeals, 2nd Circuit, however, reversed the decision of the Tax Court and held that the premium payable on the policy was not includible in the gross income of Casale. The Appeals Court based its determination on the grounds that the policy was a corporate asset subject to prior claims of corporate creditors in case of insolvency, and that Casale had received no immediate benefit, merely a tentative one, since the cor-

poration's insolvency could terminate his interest.

CORPORATION AS A SEPARATE ENTITY

In its opinion, however, the Court of Appeals went far beyond the immediate issues and discussed the broad principles underlying the problems of compensation arrangements of any kind made by closely-held corporations with controlling stockholder-employees. In its decision, the Court defined this issue as follows:

> Are corporate expenditures of a corporation actively engaged in business deemed to be proportionate distributions to controlling stockholders for tax purposes?

The Court then went on to state:

> The record does not indicate any contention by the Commissioner that the corporation itself is a sham or alter ego for all purposes . . . We have seen that taxpayer has received no immediate personal benefit from the corporate purchase of the policy. *We have been cited to no case or legislative provision which supports the proposition that the entity of a corporation which is actively engaged in a commercial enterprise may be disregarded for tax purposes merely because it is wholly owned or controlled by a single person.* (Emphasis supplied.)

The Casale dictum, if followed in subsequent court cases, will be of considerable importance in aiding the acceptability of profit-sharing, pension, and other types of fringe benefits and deferred compensation arrangements made by closely-held corporations with their officer-stockholders.

As indicated previously, Casale's death benefit and retirement plan was funded by a $50,000 life insurance policy of which the corporation was named as beneficiary. Suppose Casale died before retirement, how would the receipt of the proceeds of the policy by the corporation and the subsequent payment of the $50,000 death benefit by the corporation be taxed? The receipt by the corporation of the $50,000 proceeds of the policy would be exempt from tax in accordance with Section 101(a). The subsequent payment of $50,000 to Casale's beneficiaries by the corporation would be deductible (assuming it to be reasonable) under Section 404. The receipt of this amount by the beneficiaries would, however, be subject to income tax except for the $5,000 death benefit exclusion under Section 101(b).

PAYMENTS TO WIDOWS

I have noted previously some of the problems inherent in the payment to officer-stockholders of closely-held corporations of salaries, fringe benefits, deferred pay plans and other types of compensation. To round out the picture, let us review the problems arising after the death of the officer-stockholder affecting payments made by the corporation to his widow or other beneficiary.

Regulation Section 1.404(a)-12, which generally relates to the deductibility of various types of non-qualified deferred pay plans, also contains a specific mention of "amounts . . . paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period)." Such payments would be properly deductible by the corporation provided that they are ordinary and necessary expenditures and meet the "reasonableness" requirements of Internal Revenue Code Section 162 or 212, that is, reasonable in view of the past services performed by the employee. As to what constitutes a "reasonable period" we can be guided by the Commissioner's ruling with respect to the term "limited period" used in the 1939 Code. In that instance he ruled that the words "for a limited period" were to be construed as a measure of the "reasonableness of the amounts to be paid rather than merely stating a time limitation for their payment" (Rev. Rul. 54-625). The

courts have held that the payment to the widow of up to approximately two years salary of the deceased employee would be considered reasonable (*I. Putnam, Inc.,* 15 TC 86 (1950)).

It should be noted that these salary continuance payments are deductible under Code Section 404, not under Section 162. As such, the payments are deductible only in the year actually paid by both cash-basis and accrual-basis taxpayers.

TAXABILITY TO WIDOW

To complete the story, let us discuss the taxability of these payments received by the widow or other beneficiary. Code Section 101(b) allows up to $5,000 of employees' death benefits to be excluded from gross income. With respect to any balance in excess of $5,000, however, we must differentiate between payments made pursuant to a contract or plan in effect before the husband's death, which are taxable, and those involving voluntary payments to widows. It is with regard to the taxability of these latter payments that we enter into an area of conflict between the Commissioner and the courts.

The Commissioner has consistently, until approximately a year ago, tried to tax voluntary continued payments of an employee's salary to his widow or heirs after his death (IT 4027, 1950-2 CB 9). The courts, with few exceptions, have viewed such payments as gifts and therefore excluded from gross income. In the summer of 1958 the Commissioner finally acquiesced with respect to cases under the 1939 Internal Revenue Code involving this issue. In TIR No. 87, dated August 25, 1958, he announced that:

> In view of a number of adverse court decisions in cases involving voluntary payments to widows by their deceased husbands' employers, the Internal Revenue Service . . . will no longer litigate, under the Internal Revenue Code of 1939, cases involving the taxability of such payments unless there is clear evidence that they were intended as compensation for services (of the widow), or where the payments may be considered as dividends.

In view of the acquiescence by the Commissioner, let us review, particularly from the point of view of closely-held corporations, the philosophy behind the court decisions that such voluntary payments to widows constituted gifts. Even the fact that the corporation made such payments in consideration for the services of the deceased employee did not alter the courts' conclusions that such payments were gifts. Thus, in its decision in *Estate of Arthur W. Hellstrom,* 24 TC 916 (1955), the Tax Court held:

> We think it makes little difference how the corporation formally expresses its motives for the payment. Where such payment is a gift, as the whole record here establishes the payments in question were, it remains a gift regardless of the fact that the corporation may state its reasons for making the payment were "because of" or "in recognition of" or "in consideration of" the services of the deceased employee. This seems to us the only sensible construction of the Supreme Court's language in *Bogardus* v. *Commissioner,* 302 U. S. 34, 44 (1937), wherein it said that a gift is none the less a gift because inspired by gratitude for past faithful services.

The underlying criteria stressed in case after case by the courts were that the gift must have been voluntarily made by the corporation, that there had been no previous plan, contract or agreement specifying such payments entered into prior to the deceased employee's death and that the widow rendered no services to the employer.

Many of the cases in point were those of closely-held corporations making voluntary payments to the widows of deceased officer-stockholders. A study of eighteen reported cases (covering the years 1948 to 1954) in which the courts ruled that

the payments made to the widow were gifts, discloses that no particular significance seems to have been placed on the shareholdings of the deceased employee. In many cases, it was significantly not even mentioned. In other cases, the decedents held 100 percent, 89 percent and 82 percent of the employer's stock with the same result (see Reinhold Groh, "Voluntary Payments to an Employee's Widow," Winter 1957-1958 issue, *Illinois Certified Public Accountant*, for an excellent analysis of the reported cases). Incidentally, these decisions, all of which decided that such payments were gifts, also placed no significance on the fact that the employer took income tax deductions for the payments. In fifteen of the eighteen cases it was specifically noted that the corporation took deductions for such payments as proper business expenses; the remaining three cases did not disclose whether such deductions had been taken.

In the recent decision in *Hilda Bounds* (262 F. (2d) 876, 12/15/58, rev'g and rem'g D.C. Md.), the Fourth Circuit Court ruled that the payments to the widow constituted a gift where such payments were voluntary and not made pursuant to a long-established plan even though the payor corporation designated such payments on its books as "compensation to officer's widow" and claimed a deduction for them on its federal income tax returns. In its decision in the *Bounds* case, the Circuit Court cited *Gladys W. Simpson* (261 F. (2d) 497, 11/7/58; rev'g D.C., So. Dist. Ill., 11/27/57; Sup. Ct. Cert. denied, 3/23/59) where, in distinction, the payments to the widow were made under a long-established plan and as a consequence were ruled not a gift to the widow but rather constituted income to her. It is interesting to note that the Seventh Circuit Court's decision in the *Simpson* case took the approach, unusual in the light of contrary determinations in the vast majority of other reported decisions, that additional evidence of the intent of the payor corporation not to make a gift was the fact that the payments were entered on the books as "special salaries" and were deducted on the corporation's income tax returns. The later *Bounds* decision gave no weight to similar action. Both the *Bounds* and *Simpson* cases involved payments to minority stockholders and were decided under the 1939 Code.

TREATMENT UNDER THE 1954 CODE

The Commissioner's decision not to litigate cases involving voluntary payments to widows (TIR No. 87, *supra*) emphasized that this policy only pertained to cases under the 1939 Code. It further stated that "the position of the Service with respect to cases in this area arising under the Internal Revenue Code of 1954 involves other considerations and will be made the subject of a future announcement." No such announcement has been issued to date.

It should be noted that all of the cited cases previously mentioned were decided under the 1939 Code. To date there has been only one reported case (*Grace P. Reed,* D.C., West. Dist. Ky., 1/16/59) covering voluntary payments to widows under the 1954 Code, which case will be discussed later. How will such payments be treated under the 1954 Code? The Commissioner will probably take the position that the change in the 1954 Code liberalizing the $5,000 death benefit provision by no longer requiring that payments be made pursuant to a plan, in effect would withdraw the complete exclusion of voluntary death payments and substitute an exemption up to $5,000. This viewpoint was expressed by Judge Dimock

of the U. S. District Court (So. Dist. N.Y.) in *Betty Rodner,* 149 Fed. Supp. 233, (1957), albeit the decision concerned the payment to a widow under the 1939 Code. Although deciding that the payments in question were gifts, Judge Dimock went on to say:

The Internal Revenue Code of 1954 (not applicable here) changed this. Sec. 101(b) . . . eliminates the provisions limiting to contractual death benefits the application of the $5,000 exemption. To me, the effect of this would seem to be to withdraw the complete exemption that gratuitous death benefits had enjoyed and to substitute an exemption up to $5,000. In the complete revision effected by the 1954 Code the general language exempting gifts is controlled by the particular language of Sec. 101(b) limiting the exemption of death benefits to $5,000. Gifts in general are exempt but gifts in the form of death benefits are taxable insofar as they exceed $5,000.

That does not seem to have been the view of the Senate Committee on Finance of a subsequent Congress, however. In the Report (No. 1622, 83rd Congress, 2nd Session) . . . p. 14, the Committee deals with this very change and says "The exclusion is made available regardless of whether the employer has a contractual obligation to pay the death benefits." That language is certainly that of someone who thinks that the new provision extends a boon instead of a burden to the recipients of gratuitous death benefits. With the utmost respect, I believe that the Committee's view of the prior law was a misinterpretation. Even if the Congress itself were to solemnly declare the meaning of legislation adopted at a previous session it would have no more effect than an executive interpretation such as I. T. 4027, *supra. Fire Companies Bldg. Corp.* v. *Commissioner,* 2 Cir., 54 Fed. (2d), 488, 489; *American Exchange Securities Corp.* v. *Helvering,* 2 Cir., 74 Fed. (2d), 213, 214. Thus, I am not required to accept the interpretation of the Senate Committee and I adhere to my view that gratuitous death benefits were wholly exempt until the effective date of Revenue Code 1954.

On the other hand, it is the opinion of many practitioners, based upon the intent evident in the Congressional Committee Reports, that the change in the 1954 Code was an attempt to liberalize rather than restrict the taxability of employee death benefits. These practitioners also believe that the rationale underlying the numerous court decisions decided in favor of the widow under the 1939 Code is still valid and that the courts will still refuse to "tax as ordinary income a payment which the payor made and intended as a gift" (*Estate of Arthur W. Hellstrom, supra*).

This view has been upheld in the only case to be decided to date under the 1954 Code. The recent decision in *Grace P. Reed, supra,* involved payments to the widow of a corporate officer who died on February 2, 1956. Shortly after his death the corporation's board of directors voted "as a material expression of sympathy and kindness" to the widow, and "motivated by a deep sense of appreciation and recognition of the past services" of the decedent, to pay to the widow an amount equal to his annual salary of $50,000 in twelve equal monthly instalments. The Court ruled that this payment "was intended to be, and was, a gift" to the widow by the corporation "within the meaning of the provisions of Section 102(a) of the 1954 Internal Revenue Code." Apparently in answer to the point raised by Judge Dimock in *Betty Rodner, supra,* the District Court included in the *Reed* decision its conclusion of law that the meaning of Section 102(a) was not changed by the provisions of Section 101(b) in the 1954 Code. The Court further stated that:

It is clear that the purpose of the latter section of the 1954 Code is to eliminate the requirement (contained in the comparable section, 22(b)(2), of the 1939 Code) that certain employee death benefits must be paid pursuant to a contractual obligation in order for such benefits to qualify for a $5,000 exclusion from gross income.

PAYMENT TO ESTATE

Voluntary payments made by the board of directors to the estate of the deceased employee rather than to his widow, would probably have different tax consequences. The first $5,000 paid to the estate would be excluded from gross income under Section 101(b). However, any amounts paid to the estate in excess of $5,000 would probably be taxable to the estate. As previously mentioned, the acquiescence of the Commissioner to treat voluntary payments as gifts under the 1939 Code (TIR No. 87, *supra*) only covered payments to widows. The courts have generally held in decisions relating to the 1939 Code that voluntary payments to the deceased employee's estate are taxable as income. In numerous additional cases decided under the 1939 Code the courts have stressed as one of their reasons for considering the payments as gifts was that the payments were made to the widow and not to the estate of the employee. Presumably the rationale in these decisions will be carried over to cases decided under the 1954 Code.

Where the deceased employee is a stockholder we must also consider the question of whether payments made to his estate or beneficiaries represent payments on account of his stock ownership rather than on account of services previously rendered by him. Where the court was able to spell out that such payments could not be considered as post-mortem payments for services rendered but were strictly an attribute of a stock redemption plan (*Graybar Electric Co., Inc.,* 2 Cir. 4/13/59, aff'g 29 TC 818 (1958)) it was held that such payments were not deductible by the corporation and constituted part of the proceeds realized on the redemption of stock by the estate.

SUBCHAPTER S

One of the provisions of the 1958 Technical Amendments Act which has aroused considerable interest added the new Subchapter S to Chapter 1 of the Internal Revenue Code (Sections 1371 to 1377). These provisions, which enable certain small business corporations to be taxed as "partnerships" or "individual proprietorships," may contain the incentive needed to cause some existing partnerships and individuals to incorporate as closely-held corporations. As corporate employees the officer-stockholders can take advantage of the tax benefits available to all employees and still continue to pay as individuals a tax on their proportionate share of the corporation's income whether or not distributed.

Among the tax benefits currently available to corporate employees under the Code are many of the fringe compensation benefits previously discussed. Thus, for example, owners of an unincorporated business cannot be covered under a qualified pension or profit-sharing plan. Corporate officer-stockholders can be so included and can participate in the real advantages inherent in such a plan. They can also be covered under group life insurance programs, accident and health plans which the corporation can purchase with "fully deductible" dollars rather than forcing the unincorporated owners to use their costly "after-taxed" profits from the business. All of these and other fringe benefits available to an officer-stockholder of a closely-held corporation could thus be made available to present partners and sole proprietors should they incorporate and elect under Subchapter S to continue to be taxed in their individual capacities.

The election to be treated under Subchapter S of the Code may also be

of great benefit in cases involving determinations of the reasonableness of compensation paid to an officer-stockholder. Generally, an election under Subchapter S will effectively eliminate any problem of unreasonableness of compensation to the stockholders as a group since they will be taxed on all corporate earnings regardless of the amount of such earnings designated as compensation to them.

It is also a possibility, as noted previously, that the courts will agree that voluntary payments under the 1954 Code to widows of corporate (Subchapter S or otherwise) employees are to be treated as gifts and are not subject to income tax. Of course, the owners of unincorporated businesses get no similar benefit under the Internal Revenue Code.

CONCLUSION

Regardless of how the officer-stockholder is compensated, we will find ourselves coming back to the recurring question of reasonableness. The viewpoint of the Internal Revenue Service is clear. Reg. Sec. 1.404(a)-1(b) specifies that "In no case is a deduction allowable . . . for the amount of any contribution for the benefit of an employee in excess of the amount which, *together with other deductions allowed for compensation for such employee's services,* constitutes a reasonable allowance for compensation for the services actually rendered" (emphasis supplied). It should be noted that this regulation specifically covers the allowability of the deduction for payments made under qualified and non-qualified pension, profit-sharing, annuity, retirement and the deferred pay plans, as well as salary continuance payments to widows, etc., after the employee's death.

The Treasury Department's attitude thus is clear. Total up for each year the aggregate compensation paid to an employee, whether that compensation be termed salary, bonus, group insurance, stock options or other fringe benefits, payments under qualified pension and profit-sharing plans, non-qualified plans, retirement and other deferred pay plans. Does the sum of these items constitute a reasonable allowance for personal services actually rendered? If the total amount is deemed unreasonable and the employee is a stockholder of a closely-held corporation, the excess over the amount considered reasonable will be taxed as a dividend. This, at least, will be the Treasury Department's point of view. The courts may not always agree, but it must always be borne in mind that the burden of proof is on the taxpayer.

GOOD MANNERS

Proficiency in accounting does not insure an appreciation of the importance of good manners nor the judgment necessary to distinguish between proper and improper behavior. Some firms try to help their staff men through detailed manuals or other types of written or oral instructions. Others take good behavior for granted and pay little attention to rules governing conduct and appearance. Although lack of standards set by employers may affect the staff morale adversely, regulations containing specific "do's" and "don'ts" will not accomplish much more. Memorizing specific solutions does not develop the faculty of judging correctly cases for which no precedent exists. Young people must be trained to recognize a general principle and to deduce from it the answer to the situation in question.

THE REPORT (Colorado Society of CPAs), May 1959

Physical Inventory By Statistical Sampling Methods

By HERBERT ARKIN

Even a 100-percent physical inventory count, which carries an illusion of absolute accuracy, is to some degree an approximation. Because of the considerable costs involved in taking a complete inventory, management should consider the many benefits to be derived from the application of statistical sampling methods. Projection of the sample, stratified sampling, specifying the sampling unit and other applicable technical features are discussed.

A KEY figure in the development of the balance sheet and income statement is the merchandise inventory value as determined in accordance with generally accepted accounting principles. The importance of this figure is recognized broadly by accountants, together with the fact that the establishment of this value is not as clear-cut a determination as ascertaining, for example, the amount of cash, accounts payable and accounts receivable, where these figures are obtained by a totaling of dollar values from subsidiary records or documents. The compilation of total values needed for the preparation of the financial statements, such as accounts payable balances, may be achieved merely by the simple addition of invoices received less payments made, as reflected on the books of account. However, inventory totals (whether or not perpetual records are maintained) are the result of complex receipts, at various values, and withdrawals, shrinkages and pilferage of equally complex forms.

In further recognition of the importance of the position of the inventory value in the financial statements of the company, it is customary for management to take a physical inventory each year in order to verify and, where necessary, adjust perpetual inventory records, where they are available, or to fix the inventory on hand by actual count and valuation. The importance of and necessity for the periodic physical inventory cannot be denied. However, the accomplishment of actual physical counts is costly and disturbing, often involving large numbers of persons working overtime, perhaps on weekends. When

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the cost of completion of the annual physical inventory is carefully computed, it may be found to be a significant percentage of the inventory value in some cases, while in many other cases a large and important expense.

APPROXIMATION ELEMENTS IN COMPLETE COUNTS

The physical inventory, sometimes called a 100-percent or complete physical inventory, has an illusion of absolute accuracy, primarily because it is thought of as a 100-percent count. However, experienced accountants will recognize that apart from, and in addition to, the numerous problems of pricing and valuation, the actual counts are to some degree an approximation. The obvious instance of the huge pile of coal at the public utility, the tonnage of which cannot be established by weighing every lump of coal, but rather by estimation, is only one of the numerous examples of such estimates of physical quantities. Counts of items in bins approximated by weighing or other estimation methods are further examples. Large quantities of packaged materials will not all be opened to ascertain that every single unit is contained in each of the multi-unit packages. Perhaps a few will be opened as a check. The millions of loose individual cigarettes in trays in a large cigarette factory cannot be individually counted nor, for that matter, even weighed to estimate the count. The total must be obtained by reasonable approximation (average number expected per tray, etc.).

Even more important, since inventory taking happens only once a year in many organizations, it is not possible to maintain year-round staffs of expert inventory takers but rather a large part of the available staff of all types must be temporarily impressed into service for a day or two to achieve this end. Because of the employment for inventory purposes of many who may not, and probably cannot, be familiar with every item in the inventory, combined with a general lack of enthusiasm for a task not directly related to their own activities and of a boring nature, errors of count and classification are bound to happen. In many cases the situation resolves itself into a problem of keeping these errors within reasonable bounds. The problem of accurately pricing or valuing numerous items is added to the problem of accurate counting and listing. It is not intended to imply that all or even many inventories are grossly inaccurate as a result. Such a situation is the exception rather than the rule. However, the point must be made that a physical inventory results in an *estimate* of the inventory value (or physical quantities) and not a precise (accurate to the nearest penny) value.

STATISTICAL SAMPLING METHOD

If valuation of the inventory through a 100-percent physical inventory results in an estimate with a varying degree of accuracy, depending on the situation, and a costly one at that, it might be well to consider that there are other methods of achieving such estimates beyond a 100-percent count, which may even result in more accurate statements of inventory values and certainly at a lower cost. Such estimates may be achieved through the use of statistical sampling. Actually the use of sampling methods for this purpose is not entirely new. Estimates of the board feet of standing timber in forest lands or the value of growing crops can only be achieved by this method. However, the use of the scientific techniques of statistical methods to achieve this end with a desired degree of precision is relatively new. While statistical sampling has been widely used in science and in-

dustry, it has only recently been finding its way into the field of accounting and in the application of such methods in auditing.[1]

THREE REPORTED APPLICATIONS

Although the concept is relatively new, statistical sampling methods for the valuation of inventory have been used. While the extent of usage in the past cannot be fixed precisely, at least three such applications have been reported in detail in the literature. These three reported applications were at the Esso Research and Engineering Co.,[2] the Minneapolis-Honeywell Regulator Co.[3] and the Argus Camera Division of Sylvania Electric Products.[4]

In the *Argus Camera* and *Minneapolis-Honeywell* cases, it was reported that prior to the use of the new sampling methods, tests were performed in which a complete (100-percent physical inventory) inventory valuation was compared with the results of a sample projection. The differences between the results obtained by two methods of valuation in both cases was a fraction of one percent. It must be remembered that it cannot be said for certain which of the two results (sample projection or 100-percent count) was more nearly correct.

PROJECTION OF THE SAMPLE

The methods of statistical sampling, when properly applied, provide a means for securing inventory valuations based on a limited sample with a known degree of reliability. The value of the sample is "projected" to obtain a total inventory valuation. The mass count of a 100-percent physical inventory with its attendant difficulties, errors and expense can be replaced by a more precise valuation of a limited number of inventory items which may then be extended to estimate, within any desired degree of accuracy, the total value of the inventory. The use of a limited sample for inventory valuation makes possible the confining of the actual count and pricing to the small group of expert personnel familiar with this area and, because of the smaller number of items involved, often makes possible a complete recheck of all items included in the sample at a much lower cost than the total count.

It is essential that any projection of a sample for inventory estimation be reliable within known and predictable limits. This objective can be obtained only through the use of statistical sampling methods. To achieve this end, it is necessary that a "probability" random sample be used for such projections. The selection of such a sample must be accomplished by resort to random number tables to make possible evaluation of the sampling reliability of the sample projection. Haphazard or judgment samples will not serve the purpose for although they may possibly provide excellent estimates, there is no way of evaluating their reliability.

The type of projection to be used will depend on the situation. Where no item-by-item perpetual or book in-

1. H. Arkin, "Statistical Sampling in Auditing," *The New York Certified Public Accountant*, July 1957, pp. 454-469.

2. R. F. Obrock, "A Case Study of Statistical Sampling," *The Journal of Accountancy*, March 1958, pp. 53-59.

3. A. L. Rudell, "Applied Sampling Doubles Inventory Accuracy, Halves Cost," *N.A.A. Bulletin*, October 1957, Section I, pp. 3-11.

4. W. E. Courtright, and A. A. Procassini, "Inventory Valuation by Sampling," *Industrial Quality Control*, February 1958, pp. 16-20.

ventory is available, the projection is made by obtaining the average value of a sample of sampling units and multiplying that average value by the total number of sampling units in the inventory. This type of approach may well be used in inventorying goods in process where no detailed book records are kept for the inventory items.

Another and more efficient type of projection may be used where a perpetual or book inventory is available. Here it is possible to obtain a sample and, for the sample, arrive at the average ratio between the physical inventory valuation and that of the book record for items counted in the sample. This average ratio can then be applied to the total inventory value determined from the perpetual inventory.

STRATIFIED SAMPLING

In any case it is not necessary that the inventory be considered as a general pool and the sample be taken from the entire inventory. Generally it is desirable and statistically more efficient that very expensive items be counted in their entirety. In addition it may be desired that certain other items, such as those easily pilferable, be counted completely or subjected to heavier sampling. It may be found desirable to segregate the inventory into general classes of items and to sample in varying degrees in the various categories.

This type of approach (stratified sampling) is particularly notable when it is remembered that in many cases the greater part, if not most, of the cost of a physical inventory, arises from the counting and valuation of small or inexpensive items which constitute only a small fraction of the total inventory value. Thus in the *Argus Camera* case, it was reported that 117 parts out of 1,066 accounted for more than 72 percent of the total inventory value. The wasteful practice of expending large sums of money in counting a very great number of items of small value, perhaps constituting a small portion of the total inventory value, can thus be replaced with a total count of the relatively few costly items and a sampling of those of smaller value.

This type of grouping (stratification) by value for sampling purposes provides an additional advantage to the statistical approach in that it guards against the effect of the few items of extreme value (skewed distribution) in its effect on the sample average.

SPECIFYING THE SAMPLING UNIT

In planning an inventory by sampling, certain physical difficulties may be encountered arising from problems involved in specifying the sampling unit. In the *Minneapolis-Honeywell* case, the sampling unit was a "lot" where the lot was defined as "any group of identical parts or assemblies which are physically touching, either by crates, bins, or skids." These lots were numbered by placing a slip on the lot and a random number table used to select the lots to be included in the sample. In the *Esso Research* application, the items to be included in the sample were obtained from the 3,900 items by numbering the punched cards for the items and selecting the sample of 716 items by resort to a random number table. This was done separately for each stratum. In other situations, other sampling units may be desirable. For instance, an area sampling approach may be useful in which a large factory or warehouse area may be divided into numerous small areas with assigned numbers and a sample of these areas inventoried and projected. A large number of work in process locations can be inventoried by a similar method. The method of definition of the sampling unit will be a function of the situation on hand considering such matters as the records available and the physical distribution of the items to be inventoried. It may

be observed that the greatest savings will result when a large number of sampling units exist or can be created.

The determination of the sample size necessary to achieve the objectives in terms of reliability of the desired projection is facilitated by the fact that in almost every instance there will be available data of detailed counts of previous inventories which will provide an indication of the variability likely to be encountered and, at the same time, will provide a basis for developing the most efficient sampling method. However, such advance determinations of sample size are at best estimates of that requirement and an appraisal of reliability based on the actual sample data is essential after the sampling has been completed.

CORRECTING PERPETUAL INVENTORY FIGURES

When, in addition to providing a dollar value for inventory, the physical inventory is used to correct the quantities in a perpetual inventory, a further problem may arise. The sample will provide corrections for quantities on the perpetual inventory only for those items included in the sample, although it does provide a projection of the total dollar disparity between the perpetual and actual inventory.

In the *Esso Research* application the projected disparity between the perpetual inventory valuation and the sample projection was charged off to a "Shrinkage" account. It was provided that items not included in the sample would be covered by a 100-percent physical inventory every five years to correct all perpetual inventory balances. Of course, a similar objective could be accomplished by a cyclical inventory spread over one or more years to correct perpetual inventory balances. It can be arranged to have the counts accomplished at slack times so as not to create new costs. Considering that expensive and pilferable items are counted in their entirety during each inventory period in most cases, a spread of such a check over several years with respect to the less expensive items can be defended.

CONCLUSION

Appreciable savings through the use of sampling methods to replace a 100-percent count generally will be dependent on the application of sophisticated sampling methods. For this reason, and to make certain that the sampling is properly planned and executed as well as to appraise the results, it will be necessary to have available the services of a competent statistician. Often such a statistician is available in some other department of a business organization such as the quality control department or market research department. It is urged that, at least for the initial effort, the services of such a statistician be secured. Careful planning and proper training of the inventory crews will be necessary.

This new method of inventory by sampling provides certain advantages to the auditor, both internal and independent. His limited capability of observing and checking a massive 100-percent inventory is greatly enlarged by the possibility of closer observation and checking of the items in the sample. The method provides, in certain instances, the possibility of an inexpensive check or recheck of a stated inventory value based on a sample which, since he is checking only for reasonableness, can be even smaller than that used by the client to project the original inventory value. The establishment of inventory valuations through properly designed statistical sampling affords considerable opportunities for monetary savings, faster determinations, valuation and greater accuracy. It is anticipated that the growth in the application of this technique will be rapid.

New York State Tax Forum

Guest Editor—PHILMORE H. FRIEDMAN, CPA

REORGANIZATION MAY SUBJECT CORPORATION TO HIGHER FRANCHISE TAX

Corporations planning a merger or other type of reorganization generally give little or no thought to the ultimate effect the transaction will have on their New York State franchise tax liability. Although the reorganization may be non-taxable for federal and New York State income tax purposes, the companies may be liable for a greater amount of franchise tax after the plan has been consummated. The following examples serve to illustrate this result.

Assume a company classified as a real estate corporation exchanges a portion of its voting stock for substantially all the assets of another corporation. The exchange qualifies as a non-taxable reorganization for federal and New York State income tax purposes. However, the real estate corporation, in all likelihood, will be reclassified to a business corporation and its real estate operations (as well as its other income) thereafter will be subject to the higher rates applicable to business corporations. Moreover, upon reclassification, the real estate corporation would be required to pay an additional franchise tax of 2 percent of its realized and unrealized surplus.

Assume Company *A* and Company *B* negotiate a merger in which *A* is to be the surviving company. *A* always has had a high rate of earnings and low allocation percentage. *B*, on the other hand, has reported low earnings but a high New York allocation percentage. The merger of *A* and *B* will result in a greater aggregate franchise tax liability than was payable by the individual companies. Under the operation of the allocation formula, a larger amount of net income will be allocated to New York than had previously been reported.

It may be worthwhile to consider the over-all effect reorganizations will have on state franchise taxes; this may be substantial even though the state tax is an allowable deduction for federal income tax purposes.

RECLASSIFICATION OF REAL ESTATE CORPORATIONS

The State Tax Commission recently considered a request for a ruling based upon the following facts. A real estate corporation, organized in New York State and subject to tax under Section 182, Article 9 of the Tax Law, sold all of its property. It retained the proceeds of sale, and its only remaining asset was cash in the bank. The taxpayer expressed its intent to hold the proceeds of sale intact until a new

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ED. NOTE: For an interim period, until a permanent departmental editor has been selected, this department will be conducted by guest contributors.

purchase is made. The question presented is whether there is any time limitation within which the corporation must purchase new real estate to avoid reclassification to a business corporation.

The State Tax Commission ruled that there is no time limitation within which the corporation must purchase new real estate to avoid reclassification to a business corporation. This appears to represent a change of position on the part of the Commission since it has been the writer's experience that the State has attempted to reclassify a real estate corporation to a business corporation where it remained inactive for a long period of time.

Assuming the real estate corporation were to invest more than 10 percent of the proceeds of sale in securities, it then would be reclassified to a business corporation on the first day of the following year. The rule which limits investments in stocks, bonds, and other securities by a real estate corporation—at the penalty of reclassification if such investments exceed 10 percent of its gross assets—can be a trap for the unwary. For instance, at the time a real estate corporation makes investments in securities the investments may represent less than 10 percent of its total gross assets. However, over the years the securities may increase in value at a greater rate than its real estate properties. Consequently, in any given year the corporation might own securities which total value exceeds 10 percent of its gross assets. Apparently, this would cause the corporation to be reclassified to a business corporation even though at the time of the original investment the value of the securities did not exceed 10 percent of its assets. It does not seem to be within the spirit of the favorable treatment accorded real estate corporations that market fluctuations should be a reason for possible reclassification.

METHODS OF COMPUTING DEPRECIATION

Accelerated methods of computing depreciation (i. e., double-declining-balance method and sum-of-the-years digits method) are available to all taxpayers (under certain conditions) for federal income tax purposes. Unfortunately, New York has not adopted the federal rules; rather, it adheres to its old policy in recognizing the straight-line method as the acceptable method of computing depreciation. Thus, unincorporated businesses are limited to straight-line depreciation. Corporations are more fortunate than unincorporated businesses in this respect. Where a corporation in its federal income tax return has computed depreciation via an accelerated method, it automatically reports the same rapid depreciation in its New York State franchise tax return. This result obtains because the "entire net income" (the base for computing franchise tax, with adjustments not here relevant) is premised upon federal taxable income.

The failure of the State to conform its method of computing depreciation with those recognized by the Federal Government results in undue discrimination to unincorporated businesses and undoubtedly necessitates that these taxpayers maintain two sets of records to show the different adjusted bases of depreciable assets under both laws. New York is actively considering adopting federal definitions of taxable income for purposes of State personal income, unincorporated business and corporation taxation. The voters of the State will cast their ballots in November to determine whether the State will be authorized to amend its constitution to permit it to adopt the federal rules. Enactment of such legislation would serve to eliminate the depreciation inequity as well as many uncertainties as to the proper treatment

of various items under the New York State taxation rules.

CORPORATE DISTRIBUTION OUT OF UNREALIZED APPRECIATION OF CORPORATE ASSETS

The New York State Court of Appeals has reversed the decision of the Appellate Division (6 A.D. 2d 393) in *Marx* v. *State Tax Commission* (decided July 1959) and has held that corporate distributions made possible by unrealized appreciation in corporate assets do not result in taxable income to the receiving shareholders.

In the cited case a corporation purchased an apartment house for $1,745,000 and gave the purchaser an F.H.A. mortgage for $1,682,000. Some years later, because of appreciation in the value of the real estate, the corporation was able to obtain from an insurance company a new mortgage of $2,000,000 and pay off the existing one, leaving itself with net proceeds of $824,800. In the same year it distributed to stockholders $735,000, of which taxpayer received $389,588. The corporation's accumulated earnings and profits at the close of that year equalled 10.6 percent of the distribution and taxpayer reported that percentage of his distribution ($41,296) as a dividend. The balance of his share of the distribution ($348,292) was treated as a return of capital and that portion ($2,174) which exceeded taxpayer's basis for his stock was reported as capital gain. The State Tax Commission assessed an additional tax based upon its finding that the entire distribution was taxable as ordinary income. The Court of Appeals rejected the Commission's contentions that either (1) the distribution was a dividend under Section 350, subdivision 8 of the Tax Law, or (2) it was gross income within Section 359, subdivision 1, under the broad definition of income derived from any source whatever, noting that the Federal Government had approved of Marx's treatment of the distribution. The Court stated that a distribution is taxable as a dividend only to the extent of a corporation's earnings and profits. The refinancing of the mortgage had no effect on the corporation's earnings and profits because the increase in cash was offset by an equally large increase in a liability, with no consequent increase in net worth. The Court concluded that unrealized appreciation does not increase earnings and profits and that distributions other than from earnings and profits are a return of capital to the extent that they do not exceed the receiving shareholder's basis for his stock.

Note that, for federal income tax purposes, Section 312(j) of the 1954 Internal Revenue Code was enacted to insure imposition of tax on such "windfall" distributions if made possible through proceeds of loans insured by the United States or any agency or instrumentality thereof, e.g., Federal Housing Administration loans. The section provides that if a corporation makes a distribution of property to its shareholders at a time when there is outstanding a loan to the corporation which was made, guaranteed, or insured by the U. S. or an instrumentality thereof and the amount of the outstanding loan exceeds the adjusted basis of the property (but without adjustment for depreciation) constituting security for such loan, the earnings and profits of the corporation are to be increased by such excess and, immediately after the distribution, are to be decreased by such excess.

Accounting at the SEC

Conducted by Louis H. Rappaport, CPA

DEPRECIATION ON REPLACEMENT VALUE

In recent years, with the increase in price levels, there has been some advocacy of a theory that depreciation should be based not on historical cost but on replacement cost. It has been argued that depreciation charges are inadequate unless they provide for the replacement of the applicable assets at the time they are retired from service. It has also been said that there is not a fair matching of costs and revenues if depreciation based on costs of fixed assets acquired at one price level is deducted from sales made at a materially different price level. Others maintain that regardless of the matching theory, costs are not correctly stated unless they fairly reflect current values of capital consumed in the business. Holders of these views would, in effect, abandon historical costs by adjusting such costs in financial statements to reflect changes in the purchasing power of the dollar.

The SEC made it clear in 1952 and 1954 (18 SEC Ann. Rep. 182 (1952); 20 SEC Ann. Rep. 107 (1954)) that it would require adherence to historical costs in statements filed with it. The Commission in fact denied a formal application to adopt a requirement that "economic" depreciation (based on replacement at current prices) be reflected either in the accounts or by other appropriate disclosures.

Without going into the merits of price-level depreciation, our readers may be interested to read of the experience of two companies which filed statements with the SEC on this basis only to have them rejected by the Commission. (These cases were discussed in *The Journal of Accountancy,* September 1959, and are cited here with the permission of that publication.)

Iowa-Illinois Gas and Electric Company deducted price-level depreciation as an operating expense in the computation of net income for the year 1958. The following explanation appeared among the notes to financial statements:

> A 1957 decision of the Iowa Supreme Court in the case of the *City of Fort Dodge* vs. *Iowa-Illinois Gas and Electric Company* gave recognition to the inadequacies of cost depreciation and permitted the recovery, through rates charged customers, of the fair value of the property used to serve customers. Rate increases which include an allowance for fair value depreciation have subsequently been obtained in certain Iowa districts.
>
> In June 1958, the Company began charging fair value depreciation to operating expenses based on the fair value of the property in those districts where such de-

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preciation had been allowed in the determination of rates. An amount equivalent to revenues collected to provide fair value depreciation ($420,000), after reduction for the estimated income tax on such increased revenues, or a net amount of $198,000, has been credited to an account for capital maintained by recovery of fair value depreciation.

The middle paragraph of the auditors' certificate read as follows:

In 1958, the Company commenced collecting increased revenues in certain of its operating areas in recognition of depreciation allowed in rate proceedings on the fair value of related property. To the extent recovered in increased rates, fair value depreciation has been recorded by the Company as set forth in the notes to the financial statements. Although generally accepted accounting principles presently provide that depreciation shall be based upon cost, it is our opinion that these principles should be changed with respect to depreciation to recognize increased price levels. We approve of the practice adopted by the Company, since it results, in our opinion, in a fairer statement of income for the year than that resulting from the application of generally accepted accounting principles. In all other respects, the financial statements were prepared in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Iowa-Illinois filed its 1958 statements as part of a registration statement with the SEC. Subsequently, the company amended the registration statement and showed the fair value depreciation of $198,000 as an appro-

priation of net income, that is, after the amount designated as "Net income." The notes to the financial statements included the following:

The provision for fair value depreciation represents an amount equivalent to revenues collected to provide fair value depreciation ($420,000) after reduction for the estimated income tax on such increased revenues, and has been credited to an account for capital maintained by recovery of fair value depreciation. The Company believes that such a provision should be reflected as an operating expense and, hence, deducted before arriving at operating income. However, the Company is informed that such treatment will not be acceptable to the Securities and Exchange Commission. Therefore, the provision for fair value depreciation is shown in the accompanying statement of income as an appropriation of net income.

The auditors gave a short-form certificate with no exception or comment.

Ayrshire Collieries Corporation filed an annual report on Form 10-K with the SEC for the fiscal year ended June 30, 1958. The statement of earnings concluded as follows:

Net income for the year	$2,884,256
Provision for price-level depreciation (see note)	195,429
Balance of net income	2,688,827
Equity in undistributed net income of affiliated companies	311,226
Net earnings, including equity in undistributed net income of affiliated companies	$3,000,053

Note: The provision for price-level depreciation represents the excess of depreciation cost measured by the current purchasing power of the dollar over depreciation cost measured by the purchasing power of the dollar at the dates of acquisition or construction of the companies' depreciable property.

The auditors gave an unqualified opinion on the Ayrshire statements in which the first two paragraphs were equivalent to a standard short-form certificate; the third paragraph read as follows:

In our opinion, however, the net income for the year is more fairly presented after deducting the provision for price-level depreciation, since current price levels have been recognized in determining the current cost of property consumed in operations. Generally accepted principles of accounting for cost of property do not reflect the effect of price-level changes since dates of acquisition or construction of the companies' depreciable property.

An amended statement was later submitted to the SEC. The amended statement concluded as follows:

Income after federal income taxes	$2,884,256
Equity in undistributed net income of nonconsolidated affiliates	311,226
Net income	3,195,482
Appropriation for price-level depreciation (see note)	195,429
Balance of net income transferred to earned surplus	$3,000,053

Note: . . . The Company believes such appropriations of net income should be deducted before arriving at net income for the year, but is informed that such treatment is not in accordance with generally accepted accounting principles and will not be accepted by the Securities and Exchange Commission.

The amended auditors' certificate was the same as the one appearing in the annual report except for the first sentence in the third paragraph which was revised as follows:

In our opinion, however, the net income of the companies for the year is more fairly presented by the amounts reported as "balance of net income transferred to earned surplus" since, in arriving at such amounts, current price levels have been recognized in determining the current cost of property consumed in operations.

Administration of A CPA Practice

Conducted by MAX BLOCK, CPA

SYSTEM AND MACHINERY DATA FOR STAFF

A number of trade publications are devoted to the dissemination of information pertaining to new ideas and methods for handling clerical work, filing, and the gathering of data. In addition, manufacturers of equipment and printers of forms issue pamphlets describing their products. These publications and pamphlets are valuable sources for information on "what's new" in these fields. Particularly where accountants are actively concerned with management advisory services, continuous perusal of these publications is mandatory.

Making this material available to staff is important. Ideas gleaned by even a junior from these publications may result in an occasional worthy recommendation to a client. Continuing contact with such material makes a staff man alert to efficiency improvement and may even be the making of a career in systems work.

MAX BLOCK, CPA (N. Y., Pa.), is a former chairman of the Committee on Administration of Accountant's Practice of the New York State Society of Certified Public Accountants. He is a lecturer at the Baruch School of Business and Public Administration of The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

Pamphlets and magazines should be made available to staff by methods dependent on the size and category of staff. One might obtain individual subscriptions to magazines for some men and circulate one copy amongst several men. There are situations where an office bulletin board might be utilized to post pamphlets or individual pages removed from magazines.

Finally, if the staff is sufficiently large, and the subject considered to be important, an office bulletin might be prepared periodically wherein there will be reported in simple terms ideas about time and labor savings methods for staff information.

CONTROL OF REQUESTS FOR EXTENSION OF TAX RETURN FILING DATE

Practitioners who find that they are required, each year, to prepare a substantial number of requests for the extension of due dates of clients' tax returns, should formalize the procedure in the interest of efficiency and control. The usual steps in this procedure are the following:

1. A decision is made to obtain an extension. This is usually done by a staff member, with approval by one authorized to do so.

2. The client is notified of this proposed action, either in advance or at a later date, according to the individual practitioner's policy.

3. The extension form and required return, if any, are prepared. Estimated tax, if any, must be determined.

4. The extension approval is received from the Director's office.

5. In some cases a second extension is requested. The procedures are the same as the foregoing.

6. The subject tax return is prepared and sent to client, with the extension approval attached.

Each of these actions requires some approval, control or follow-up. The decision to request an extension requires approval. Notification to the client is an action to be taken at a stipulated time and may require follow-up. Preparation of the forms requires assignment and observance of due dates. The estimated tax, where required, must be carefully computed, to minimize interest expense. Receipt of the Director's approval must be checked and the form filed for easy availability when required. All of these procedures can be formalized and controlled.

One form, covering several of the steps, is here submitted. Forms used by other practitioners are solicited for review and publication.

EXTENSION REQUEST WORKSHEET

1. Please fill in for BOTH FEDERAL AND STATE RETURNS, so that both extensions can be typed at the same time. If State extension is not desired, make notation and give explanation.
2. Tax file must, wherever possible, accompany this request.
3. Place in staff room bin marked 'ROUTE TO TAX DEPARTMENT'.
4. The same worksheet used for a client's initial extension request is also to be used for the final (or second) request.

CLIENT: ______________ (Insert correct corporate name) ADDRESS: ______________ MAIL TO ATTENTION OF: ______________

MAILING ADDRESS (If not to be mailed to address indicated above): ______________

INITIAL EXTENSION REQUEST Form No. or Name of Return	Year Beginning	 End	Due Date of Return or Extension	Remittance	Total Extimated Tax	Official Address Where Return is to be Filed
FEDERAL:						
STATE(S): 1.	XXXXXX	XXXXXX				
2.	XXXXXX	XXXXXX				
3.	XXXXXX	XXXXXX				
4.	XXXXXX	XXXXXX				
5.	XXXXXX	XXXXXX				
6.	XXXXXX	XXXXXX				
FINAL EXTENSION REQUEST						
FEDERAL:	XXXXXX	XXXXXX				XXXXXXXXXX
STATE(S):	XXXXXX	XXXXXX				XXXXXXXXXX

REASON FOR EXTENSION: (Not to be typed)

CALCULATION OF ESTIMATED TAX:

FEDERAL	STATE

	INITIAL EXTENSION			FINAL EXTENSION		
	Name	Federal Date	State Date	Name	Federal Date	State Date
Preparation						
App. (Partner)						
Assembly						
App. (T. D.)						
Mailed						

CPA'S FILES HELD BY ATTORNEY—CONFIDENTIAL STATUS

Occasionally, perhaps very rarely, an accountant is faced with the difficult problem of having the Treasury Department make a demand for a client's work papers, or for such papers to be subpoenaed in a legal action. Unfortunately, an accountant's files, unlike an attorney's files, are not considered confidential for legal purposes.

In a recent case there was raised the interesting question of whether an accountant's papers which had been turned over to and became part of an attorney's file acquired a confidential status. The court answered in the negative (*U. S.* vs. *Thomas Boccuto,* D. C. N. J. 8/4/59). However, a prior District Court decision (*Application of J. M. House,* 144 F. Supp. 95) dealing with the same problem answered in the affirmative. Thus, the issue is in suspense and very likely will have to be resolved by a higher court.

PURCHASED CLIENTELE—TAX DEDUCTION FOR LOSSES

The investment in clients acquired by purchase constitutes a capital asset, ordinarily, and is non-depreciable for tax purposes. Eventually, one or more of the purchased clients will be lost for various reasons. Such loss probably creates a tax deduction if the purchase agreement contains an allocation of the consideration amongst the clients, individually; or, any other schedule of allocation may serve the purpose, if acceptable to the Internal Revenue Service.

An incidental advantage that may result from the allocation of cost to each client to be purchased is that a more careful scrutiny of each one will very likely be made. An intriguing question suggests itself in the application of this principle to the case of a purchase of a partnership interest. Where a specific portion of the total price is applied to an interest in specific clients, will a loss of a client provide a proper loss deduction?

TAX DEPARTMENT CONTROLS—GIFT TAX ADDITION TO COST BASIS

A change in the gift tax law permits the addition of the gift tax to the cost basis of the related gift, as limited by the statute. Where substantial gifts and tax are involved, the tax benefit to the donee in the event of a sale, or for annual depreciation purposes, may be considerable. Thus, accountants who prepare gift tax returns would render a valuable service if they advised both the donor and the donee of this new privilege and its effect on the specific gift involved. The donee should be informed at least of the following: donor's adjusted cost basis of the property, gift tax to be added thereto, and the fair market value of the property. The advice should be in such form as would constitute satisfactory evidence to a gift tax examiner; therefore documents that would help establish the facts should be part of the data.

In addition, where additional gift tax is assessed upon examination of a return, a retroactive revision must be made of the cost basis and of the depreciation deductions taken, if any.

All of the foregoing procedures can be controlled by one form designed as a check list of all steps and follow-ups that are necessary. The form should be attached to the file copy of the return so that it is readily perceptible when the return is referred to. If desired, a duplicate form could be filed separately in a chronological or other file for future reference.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

EMPLOYMENT TAX TREATMENT OF TIPS RECEIVED BY BANQUET WAITERS

The general rule set forth in the "Employer's Tax Guide" issued by the Internal Revenue Service (Publication No. 15, revised January 1959) provides that tips or gratuities paid directly to an employee by a customer and not accounted for to the employer, are not covered for federal withholding, social security or federal unemployment taxes. New York State, on the other hand, taxes tips or gratuities for unemployment insurance purposes and provides that the actual value of such gratuities, or the value stated in the rules and regulations promulgated by the Industrial Commissioner, shall constitute remuneration. For New York State withholding tax purposes, the State Tax Commission has declared that wages do not include tips or gratuities paid to an employee by a customer and not accounted for to the employer. However, as in the case of the federal income tax, New York State requires that the recipient of the gratuity report the same as income in his personal income tax return.

Neither the federal nor the New York State instruction guides for the employer makes any reference to the new federal tax ruling on tips issued October 16, 1958, in which the Internal Revenue Service changed its position with reference to certain types of gratuities collected by hotels which serve catered or banquet meals, and disburse these amounts to the employees. The new ruling, which became effective January 1, 1959, provides that where amounts to be distributed to employees are included in the hotel bill for use of its facilities, such amounts will be considered service charges rather than tips and, when paid to the employees, will be deemed wages and subject to the federal taxes for social security, unemployment insurance and withholding tax on wages. (CCH, Standard Federal Tax Reporter, Vol. 6, 1959, para. 6288.) Under the old federal rule, the service charges received by the banquet waiter were not reported as taxable wages by the hotel. It should also be noted that the New York State rule remains the same for unemployment insurance purposes. Rule 4 of the New York State Unemployment Insurance Rules and Regulations provides that the value of gratuities or tips received by a service employee serving catered or banquet meals shall be 100 percent of his

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SAMUEL S. RESS, an associate member of our Society since 1936, is a member of the New York and Massachusetts Bar. He is engaged in public practice in his own office in New York City specializing in payroll taxation and labor-management matters. Dr. Ress was formerly a member of the Society's Committee on New York State Taxation and chairman of its Subcommittee on Unemployment Insurance.

"cash wages" except when the employer submits a sworn statement that no tipping by collection or otherwise is permitted. This formula should be followed in reporting the remuneration of banquet waiters to the New York State Unemployment Insurance regardless of the amounts required to be reported for federal purposes. The unemployment insurance referee ruled in Case No. 516-69-57R that the value fixed by the Industrial Commissioner under Rule 4 (b)(3) (100 percent of cash wages) was to be conclusive and binding on the employer, the employee and the Industrial Commissioner.

APPORTIONMENT OF VACATION PAYMENTS FOR EXPERIENCE RATING

Employers who want to eliminate artificial fluctuations in quarterly payroll (which have an adverse affect on unemployment insurance tax rates) as a result of making advance payments in one quarter for a vacation period that was wholly or partially in the following quarter, must apply to the Industrial Commissioner in writing by October 1st each year. Apportionment will not be made automatically by the State.

STOCKHOLDER-OFFICER AS CLAIMANT

In Appeal Board Case No. 69,722-59, claimant was the president of a real estate corporation. His wife, two children and he were each the holders of 25 percent of the capital stock. The principal asset of the corporation was an apartment building taken over by a governmental agency and condemned in February 1959. All the assets of the corporation having been tied up, the claimant sought employment as a building manager. The Appeal Board found that the claimant was in a different situation from that of the usual corporate stockholder or officer who files a claim for benefits during a temporary shutdown or slow period. In the instant proceeding the assets of the corporation had been tied up not by any act or desire which originated with the corporation but because of extraneous circumstances over which the corporation had no control. Under those circumstances the claimant was deemed totally unemployed.

In Appeal Board Case No. 68,249-59, the Appeal Board overruled the Referee and the Industrial Commissioner who had concluded that the claimant, a licensed civil engineer, may not be deemed to be totally unemployed and therefore not entitled to benefits on the theory that he continued his association as an officer and controlling stockholder of a going corporation, the business of which was merely suspended during a slack period. The record in the case showed that the corporation had no physical assets. It had been engaged previously as a highway construction contractor, had become insolvent, and had been unable to obtain any credit. The fact that the corporation had taken no steps to formally dissolve was deemed of no significance by the Board.

Claimant had received a number of weekly salary checks from his corporation which did not have sufficient funds on deposit in its bank account. These checks had remained uncashed by the claimant. The corporation had assets consisting of $1200 of accounts receivable, and $18,000 in liabilities. The claimant's right to unemployment benefits was upheld.

Federal Taxation

Decisions and Rulings—RICHARD S. HELSTEIN, CPA

Commentary —Committee on Federal Taxation
Chairman, HERBERT M. MANDELL, CPA

DECISIONS AND RULINGS

LARGE CURRENCY TRANSACTIONS

Secretary of the Treasury Anderson has sent a letter to all banks and other financial institutions recalling to them the requirement to report on form TCR-1, all large and unusual currency transactions. Those transactions which are required to be reported are transactions involving: (1) $2,500 or more of U. S. currency in denominations of $100 or higher; (2) $10,000 or more of U. S. currency in any denomination, or (3) any currency transaction which is unusual for the business, industry or profession of the person or organization concerned. (Treasury Department Release No. A-590, 8/3/59.)

These reports are made the basis of special investigation by the Internal Revenue Service. In order, therefore, to avoid undue hardship, it is necessary that any taxpayer engaging in such a transaction keep special and complete records thereof. If the transaction is an accommodation, the taxpayer should obtain as much information as possible, including unequivocal identification of the person served. If the latter is not available, the accommodation is not advisable.

DEPRECIATION

The Third Circuit Court of Appeals has reversed the District Court in the *Hertz Corporation* case (see discussion, NYCPA, October 1958, p. 755). The Circuit Court held that the regulations promulgated in June 1956 applied to earlier years because useful life, for depreciation purposes, has always meant the useful life to the particular taxpayer claiming the depreciation. It held that useful life does not mean economic life.

In addition, the Third Circuit ruled that rental automobiles have a useful life of less than three years and therefore cannot be depreciated under the declining-balance method. It also stated that under the declining-balance method, an asset may not be depreciated below a reasonable salvage value. (*Hertz Corporation* v. *U. S.*, CA-3, 7/6/59.)

This decision creates a clear conflict with the Ninth Circuit Court of Appeals in the case of *Robley H. Evans, et al* v. *Commissioner* (discussed in NYCPA, April 1959, p. 309). The probabilities are that the Supreme Court will grant certiorari for review.

CHANGE IN PLAN
OF LIQUIDATION

A corporation, the stock of which was widely held, sold all of its operating properties and business. After the sale the company had only cash and notes receivable as assets. At a special meeting of the stockholders it was voted to completely liquidate the corporation and a partial distribution was authorized. Subsequent to the distribution, a new board of directors voted to use the remaining assets to purchase another business and to discontinue the complete liquidation of the company.

The Commissioner has ruled that because the new business did not require the amount of capital needed in the old business, the original distribution would qualify as a partial liquidation under Section 346(a)(2), IRC 1954, and would not be treated as a dividend. The fact that the original plan was one of total liquidation and was subsequently changed would not cause the previous distributions to be treated as dividends (Rev. Rul. 59-240, IRB 1959-29, 7).

SALE AND LEASEBACK

A taxpayer operating a department store sold it for cash at a price equivalent to its fair market value and took back a lease for 30 years and 3 days from the vendee in an arms-length transaction. The taxpayer suffered a loss on the sale, which it deducted on its return.

The Commissioner disallowed the loss on the basis that the transaction, as a whole, was one on which no gain or loss is recognized under Section 112(b)(1), IRC 1939. His Regulations 111, Section 112(b)(1)-1, specifically delineates as a non-taxable exchange of properties of like kind, the exchange of real estate by a non-dealer for "a leasehold of a fee with 30 years or more to run for real estate or improved real estate . . ." (cf. Regulations under the 1954 Code, Section 1.1031(a)-1 where the example is the reverse, i. e., the exchange of a leasehold for real estate).

The taxpayer contended that there was not one transaction, but two: the sale and the lease. This brought into question the validity of the above-quoted portion of the Regulations. (The 8th Circuit had already held that: "The regulation, in force for many years, has survived successive reenactments of the Internal Revenue Acts and has thus acquired the force of law." (*Century Electric Co.* v. *Com.*, CA-8, 1951, 192 F. (2d) 155, cert. den. 342 U. S. 954.)

The Second Circuit decided it did not have to rule upon the regulations since it held that there was actually a sale rather than an exchange. To quote:

> . . . we think the petitioner here, by its unconditional conveyances to a stranger, had done more than make a change in the *fact of ownership;* it was a change as to *quantum* of ownership whereby . . . it had "closed out a losing venture." By the transaction its capital invested in the real estate involved had been completely liquidated for cash to an amount fully equal to the fee . . .

Thus, the Court rationalizes, there is not here a transaction wherein the taxpayer has maintained its same economic position. (See *Fairfield S. S. Corp.* v. *Com.*, CA-2, 1946, 157 F. (2d) 321.) Here the taxpayer has closed out a losing venture in exchange for cash and an annual rental. Since there is a sale, Section 112(b)(1) cannot apply. (*Jordan Marsh Co.* v. *Com.*, CA-2, 8/13/59.)

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In view of the change in the example presented in the 1954 Code regulations, referred to above, one may wonder if this provision still has "the force of law" as held by the Eighth Circuit.

DEDUCTIONS BY STOCKHOLDER-TENANTS OF COOPERATIVE HOUSING CORPORATIONS

Section 216(a), IRC 1954, provides for the deduction by a tenant-stockholder of a cooperative housing corporation of his proportionate share of the real estate taxes and interest paid to such corporation within the tenant-stockholder's taxable year. Section 216(b), in defining a "cooperative housing corporation" requires, inter alia, that 80 percent of the gross income for such taxable year be derived from tenant-stockholders.

Thus, where the taxable years of the corporation and the tenant-stockholder end on the same date, it can be determined prior to the due date of the tenant's return whether the corporation qualifies within the provisions of Section 216(b). However, where the taxable years differ, a real problem arises. Where, for example, the tenant reports on a calendar year and the corporation employs a fiscal year ended September 30, how shall the tenant treat those payments made in October, November and December of 1958?

The Commissioner has ruled that since each year stands on its own insofar as the corporation's qualification is concerned, it cannot be determined until after September 30, 1959 whether the 80-percent test has been met. Accordingly, at the time the tenant's return is due, the corporation has not qualified and the tenant's payments are not deductible. When it has been determined that the corporation qualifies, claims for refund or amended returns must be filed claiming such payments (Rev. Rul. 59-257, IRB 1959-32, 13).

COMMENTARY

DEDUCTIBILITY OF LOSSES FROM SALES OR ABANDONMENTS UNDER SECTION 337

If a corporation adopts a plan of complete liquidation and distributes all of its assets to its shareholders within 12 months after the adoption of such plan, gain or loss is not recognized on sales of the corporation's property during the 12-month period (Section 337). When such a corporation has some assets which are worth more than their tax bases and some of which are worth less, it undoubtedly would like to arrange the sales so that the losses would be deductible and the gains non-taxable.

The obvious method of achieving this result is to sell the loss properties before the plan of liquidation is adopted and the appreciated properties thereafter. With this possibility in mind, Regulations Section 1.337-2(b) provides that the date of the adoption of the liquidation plan is ordinarily the date the shareholders approve a resolution providing for such plan. Where substantially all of the corporate assets are sold either before or after the date of the shareholders' approval of the plan, then that date is the governing date for the application of Section 337. The regulation goes on to say:

"In all other cases the date of the adoption of the plan of liquidation shall be determined from all the facts and circumstances." This sentence indicates that in cases where the loss

sales precede the shareholders' action and the gain sales follow it, the Internal Revenue Service might claim that the plan of complete liquidation was actually adopted prior to the loss sales. If such contention is upheld, then depending upon whether distribution of the assets was made within 12 months of the plan adoption date as so determined, either the losses would not be deductible, or both the gains and losses would be recognized.

The case of *Virginia Ice and Freezing Corporation,* 30 TC No. 132 (1958), dealt with this problem. The corporation owned eight ice plants. Two of the plants were sold at a loss shortly before the shareholders adopted the liquidation plan, while the other six were sold at a profit shortly thereafter. The Court allowed the corporation to deduct the loss on the two plants, pointing out that the plan of liquidation could not have been adopted prior to such sales because the requirements of state law were not met until after the sales. In the first case on this point, therefore, the taxpayer was permitted to split the loss and gain sales by careful compliance with the formalities of the applicable local law.

COMMITTEE ON FEDERAL TAXATION

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Norman E. Auerbach, CPA, *Lybrand, Ross Bros. & Montgomery*
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The same result was permitted by the I.R.S. itself in Revenue Ruling 57-140. The taxpayer involved was a publicly held corporation. The loss sales preceded the adoption of the liquidation plan by more than a year and, because of the actions by the corporation in the interim, the Service was satisfied that there was no connection between the loss and profit sales.

Consideration should also be given to the abandonment of loss property rather than the sale thereof, once a plan of complete liquidation has been adopted. It would appear from a literal reading of Section 337 that the non-recognition provision is limited to sales and exchanges but not to abandonments. Therefore, high-basis low-value assets should be looked at with a view toward comparing the sales proceeds with the possible tax savings resulting from claiming an abandonment loss.

SUBCHAPTER S CORPORATIONS AND THIN CAPITALIZATION

When Subchapter S was added to the Code in 1958, several corporate tax problems appeared to have been eliminated. One, in particular, was the problem relating to "thin capitalization." As long as the corporate distributions and repayments on stockholders' loans did not exceed current earnings and undistributed Subchapter S net income of prior years, it was reasoned that there could be no adverse affect if a Subchapter S corporation was deemed to be thinly capitalized.

Recently proposed regulations on Subchapter S (Section 1.1371-1(g)) state than an electing corporation may be denied Subchapter S status if debt to stockholders is not recognized as a corporate obligation for federal income tax purposes. The Treasury Department has taken the position that stock improperly designated as a debt

obligation may actually be a second class of stock. Since Section 1371 states that a corporation having more than one class of stock is ineligible to elect the provisions of Subchapter S, one can follow the Treasury Department's reasoning.

In *Colony, Inc.*, 26 TC 30, the Tax Court held that stockholders' loans which were disproportionate to stockholdings and which did not qualify as debt for tax purposes were similar to preferred stock. Should this provision of the proposed regulations be adopted, the stockholders of electing Subchapter S corporations must take all the precautions they took in the past with respect to thin capitalization. A possible solution to this problem is to have the stockholders contribute the debt as capital surplus in proportion to their respective stockholdings.

INCOME TAX BASIS OF PROPERTY RECEIVED BY GIFT

Under the new 1958 law, Section 1015(d) was added to the Code to provide that gift taxes paid by donors may, with certain limitations, be added to the basis of the property for income tax purposes. Suppose the same property was the subject of a series of successive gifts; would the basis of the property be increased by the gift taxes paid by each of the donors? To determine the answer to this question, let us assume that Mr. F. gave his wife 1,000 shares of X stock in 1950. In 1956, Mrs. F. gave these shares to her son John as a gift. In 1959, John made a gift of the identical shares to his wife. Is the basis of the 1,000 shares in the hands of John's wife to be increased by all of the gift taxes paid in 1950, 1956 and 1959?

In a series of gifts of the same property before September 2, 1958, the only gift taxes which can increase the basis are those paid on gifts to the donee *holding the property on that date*. Thus, the basis to John (the holder on September 2, 1958) would be increased by the gift tax paid by his mother in 1956. Any gift tax paid by Mr. F. in 1950 would not increase the basis. However, all gift taxes paid on a series of gifts of the same property after September 2, 1958 would increase the basis.

Thus, the basis of the 1,000 shares of X now held by John's wife would equal the cost or other basis of the stock to Mr. F. (the first donor), plus the applicable gift taxes paid by Mrs. F. in 1956 and by son John in 1959.

It should be noted that, under the 1958 law, the income tax basis can never be increased to an amount greater than the market value of the property on the date of the gift.

INSURANCE ON LIFE OF SURVIVOR IN CONNECTION WITH BUY-SELL AGREEMENTS

Buy-sell agreements whereby a surviving stockholder is obligated to purchase the interest of a deceased stockholder are often funded by life insurance, each stockholder owning the policy on the life of the other. Upon the death of one stockholder, a problem is presented as to the disposition of the policies on the survivor's life which were owned by the decedent, and the includibility of such insurance in the taxable estate of the deceased.

The agreement usually provides the key, not only to the disposition but to the tax consequences of the arrangement. Three possibilities present themselves. The agreement may:

1. Fail to make any provision for the disposition;

2. Provide that the survivor may purchase his policy from the estate for its cash surrender value; or

3. Provide that the estate is to assign the policy to the survivor, without payment, as a part of the buy-sell arrangement.

When the agreement is silent, the survivor may purchase the policy from the estate, or the estate may turn it in for its cash value. Since the policy is an asset of the estate, it is includible in the gross estate for tax purposes. If the agreement gives the survivor the right to purchase the insurance on his life, it is also includible in the gross estate.

Where the policy is to be turned over to the survivor without the payment of a consideration, separate from the amount paid for the stock, the taxability to the estate will hinge upon the effectiveness of the buy-sell agreement to fix values for estate tax purposes (see Regulation Section 20.2031-2(h)).

If the agreement is effective for estate tax purposes in fixing values and, in connection therewith, the survivor receives the stock and insurance policy for the consideration stated in the agreement, the value of the policy should not be taxed to the estate since the consideration received is in payment for both the stock interest and the insurance policy as an integral part of the buy-sell arrangement. If the agreement is not effective in fixing values for estate tax purposes, then the insurance will be separately valued as a part of the taxable estate, along with the fair market value of the stock.

It is suggested that buy-sell agreements clearly set forth the disposition to be made of the insurance on the survivor's life so that the value of the policy is not taxed twice if it is the intention of the parties to include such insurance in determining the consideration paid by the survivor.

POSSIBILITY OF REDUCING ACCUMULATED EARNINGS TAX

Many taxpayers who are in danger of incurring the accumulated earnings tax hold U. S. Treasury bonds as investments. At the present time, because of depressed market conditions, these bonds frequently can be sold at a tax loss. Although the loss would result in a capital loss which is not deductible by a corporation for income tax purposes (except against capital gains), the loss is deductible under Section 535 in computing accumulated taxable income. This additional deduction could minimize or eliminate the accumulated earnings tax or, in the alternative, could remove the necessity of paying dividends in a given year. The proceeds of sale of the bonds could be reinvested in other Treasury bonds of dissimilar maturity and coupon rate. The ideal situation would be to reinvest in coupon bonds maturing in less than five years which, at present, can be purchased at less than par value. At the maturity of these bonds a capital gain will be realized which will be offset for income tax purposes by the loss incurred on the previous sale through operation of the five-year capital loss carryover provisions. Under these circumstances the capital gain, which is a long-term gain, would not be included in accumulated taxable income in the year of maturity of the newly acquired bonds under Section 535(b)(6).

Classified Section

RATES: "Help Wanted" 20¢ a word, minimum $5.00. "Situations Wanted" 10¢ a word, minimum $2.00. "Business Opportunities" 15¢ a word, minimum $3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

ADDRESS FOR REPLIES: Box number, The New York Certified Public Accountant, 355 Lexington Avenue, New York 17, N. Y.

SITUATIONS WANTED

Immediately Available, accountants, office managers, bookkeepers. Bookkeepers & Accountants Division, Maxwell Employment Agency, 130 West 42nd Street, N. Y. C., telephone LOngacre 4-1740.

Financial Executive, CPA, law degree, many years diversified experience, public, private, recently assistant comptroller national manufacturing company seven years, seeks more challenging opportunity, salary open. Box 1822.

CPA, attorney, tax specialist, former revenue agent and technical adviser, seeks per diem arrangement involving tax research, planning, protests, and audits. Box 1823.

Financial Reports, tax returns, etc., typed expertly, experienced, electric, picked up and delivered, reasonable rates. L. Corona, MU 7-3890, FI 7-1312.

N. Y. CPA, age 34, northern N. J. resident, specialist in motor transportation, with excellent experience in many diversified industries, currently working private company with $4,000.00 outside practice, interested in per diem work with partnership as goal if practice expands, have contacts. Box 1824.

Accountants Reports, expertly typed on IBM, accurate, attractive, low rate, hourly, monthly, call evenings. LE 4-8336.

CPA, member of State CPA Society, many years diversified experience, seeks per diem work, available three days a week. Box 1825.

CPA-Attorney, 15 years experience with top firm, in charge major audit engagements, tax exam and appeals experience, seeks position leading to partnership. Box 1826.

CPA, formerly assistant controller and tax accountant with textile manufacturing company, seeks comparable position by way of referrals from practitioners having textile clients and other types. Box 1835.

Junior Accountant, female, recent graduate, four years diversified bookkeeping experience, desires public accounting experience. Box 1837.

CPA, 31, personable, desires responsible position in private accounting with progressive firm, nine years extensive public accounting experience. Box 1840.

CPA, 13 years diversified experience in taxation and auditing, knowledge of IBM, desires challenging position in public or private. Box 1845.

Per diem, CPA, 14 years experience, L. I. resident, 10 days monthly. Box 1846.

CPA, 33, member of N. Y. S. Society, 10 years public experience, desires permanent position with large or growing private firm as assistant to controller or in tax department. Box 1847.

CPA, attorney, tax specialist, former revenue agent and technical adviser, seeks per diem arrangement involving tax research, planning, protests, and audits. Box 1848.

CPA, tax accountant, LLM taxation, experienced tax research, planning, protests and petitions, available per diem N. Y. C. area. Box 1851.

BUSINESS OPPORTUNITIES

Mail and Telephone Service, desk provided for interviewing, $6.50 per month, directory listing. Modern Business Service, 505 Fifth Avenue (42nd Street).

Practice Wanted, substantial terms, knowhow offered overburdened or retiring practitioner, CPA, N. Y., N. J., AICPA, IE, MBA. Box 1827.

Well Equipped CPA Firm, will purchase all or part of the practice of overburdened or retiring accountants, substantial cash or attractive retirement arrangements will be offered. Box 1828.

Certified Public Accountants, midtown, practice $125,000 to $150,000, seek merger with practitioner grossing $75,000 or better. Box 1829.

We Act As Your Secretary, mail, telephone service, $5.00 per month, mail and messages forwarded, private desks and offices available, convenient to all transportation. Abbott Service, 147 W. 42nd St., Cor. Broadway.

BUSINESS OPPORTUNITIES

Professional Systems Consulting Service, available to assist practitioner's staff in these areas: IBM, data processing, production control, paperwork simplification, communications and space utilization. Systems Associates, Box 2862, Grand Central Station, New York 17.

CPA, who has adopted electronic machine method of posting the G/L that has proved highly time saving and effective seeks association with CPA firm to learn the new technique and be available for overflow work. Box 1830.

Mail, telephone, listing, desk space, in private and semi-private new attractive offices. Radio City Business Service, Inc., 570 Fifth Avenue, New York 36, N. Y., CIrcle 5-3111.

CPA, N. Y., desires to purchase practice or individual accounts in N. Y. C. or Long Island, will consider partnership arrangement. Box 1831.

CPA, age 32, $12,000 quality growing practice covered without help now, seeking similarly situated practitioner, object: sharing first moderate overhead expenses, mutual emergency coverage, and future partnership. Box 1832.

CPA Firm, $40,000.00 practice, will purchase or manage practice, funds available, consider merger or any practical association for mutual advantage. Box 1833.

We Are Interested in purchasing the entire capital stock of a corporation with a minimum loss carry forward in the sum of $200,000.00 preferably whose operations were in the import or export line of soft goods or in the domestic textile field. Box 1834.

CPA, AICPA, NYSSCPA, 41, wishes to purchase practice of retiring practitioner, tactful, personable, experienced. Box 1836.

CPA, age 39, practice $13,000, 50% free time, seeks partnership with overburdened practitioner. Box 1838.

CPA, NYSSCPA member, $10,000 gross, two days per week available time, seeks association with overburdened practitioner. Box 1839.

CPA, with small practice, Society member, 10 years diversified experience, seeks association with practitioner or firm offering growth to partnership status. Box 1841.

CPA, 33, 11 years experience in public accounting wishes to purchase either partnership interest, preferred, or practice in N. Y. area, substantial funds available. Box 1842.

CPA, N. Y., seeks purchase of entire practice, individual accounts or partnership interest, cash or retirement income plan available. Box 1843.

Tax Lawyer, Harvard, Phi Beta Kappa, former treasury department attorney, now associated with well known law firm, desires office space and facilities with accountants, tax lawyers or lawyers in general practice. Box 1844.

CPA, with attractive office in Broadway-Chambers Street area wishes to share same with another practitioner, $35.00 per month. WO 2-0570.

CPA, young, 12 years accounting experience, proven ability, personality, tact, seeks association with overburdened practitioner or one planning retirement. Box 1849.

Young, medium sized CPA firm, New York City and Long Island offices, desires to enlarge established practice, will offer attractive plan for merger or purchase of your practice, will be happy to work with practitioners who contemplate retirement with continuity, now or in the future, your reply will be treated in strict confidence. Box 1850.

PROGRESSIVE COMMERCIAL FINANCE COMPANY

is looking for two experienced accountants for outside audit work. One job is in New York, the other in the Middle West. Starting salary $7,500.00. All applications will be answered and treated in strictest confidence.

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